

ARE SOVEREIGN WEALTH FUNDS A THREAT TO
AUSTRALIA'S NATIONAL SECURITY?

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MASTER OF MILITARY ART AND SCIENCE
Strategy

by

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The opinions and conclusions expressed herein are those of the student author and do not necessarily represent the views of the U.S. Army Command and General Staff College or any other governmental agency. (References to this study should include the foregoing statement.)

ABSTRACT

ARE SOVEREIGN WEALTH FUNDS A THREAT TO AUSTRALIA'S NATIONAL SECURITY? by Major Richard I. Mogg, 130 pages.

Certain nations are growing unprecedented wealth from oil and gas revenue and large trade surpluses, and are investing at unprecedented levels in other countries via Sovereign Wealth Funds (SWFs). SWFs continue to increase rapidly in quantity, size and reach, placing ownership of domestic industries in the hands of foreign governments. This study investigates if SWFs are a threat to Australia's national security, either directly by effecting Australian domestic industry, or indirectly by exacerbating corruption and instability in the Asia Pacific region. Four threat categories are investigated: 1) influence of company plans, 2) geo-political influence, 3) access to sensitive technology, and 4) the ideological concern of a shift of the free market paradigm. There are benefits, challenges and opportunities resulting from SWFs. This study finds there is a dilemma as nations want to attract the benefits, while safeguarding against challenges. This study concludes that SWFs do not meet the definition of a threat to Australia's national security, a definition that must be reserved for only the most critical security concerns, but do present complex policy challenges, and require monitoring and ongoing management by Australian policy makers.

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ACRONYMS

ABCA	America, Britain, Canada, Australia, New Zealand Armies program
ADF	Australian Defence Force
CGSC	Command and General Staff College
CIC	Chinese Investment Corporation
CPPIB	Canada Pension Plan Investment Board
DJIMO	Department of Joint, Interagency and Multinational Operations
DMO	Defence Materiel Organisation (Australia)
FIRB	Foreign Investment Review Board (Australia)
FDI	Foreign Direct Investment
FPDA	Five Power Defence Arrangement
IMF	International Monetary Fund
MMAS	Master of Military Art and Science
OECD	Organization of Economic Cooperation and Development
PNG	Papua New Guinea
PRC	Peoples Republic of China
SAFE	State Administration of Foreign Exchange (China)
SOE	State Owned Enterprise
SWF	Sovereign Wealth Fund
UAE	United Arab Emirates
U.K.	United Kingdom
U.S.	United States of America

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CHAPTER 1

INTRODUCTION

“It is not the strongest of the species that survive, nor the most intelligent, but the one most responsive to change.”

Charles Darwin¹

Background

The nature of threats to national security can change significantly in a short space of time, leaving a nation poorly prepared to confront these threats. A new challenge is emerging; a challenge that is poorly understood and non-traditional in nature. The international balance of power is shifting as certain nations grow unprecedented wealth from oil and gas revenue and large trade surpluses. These new massively wealthy countries are investing at unprecedented levels in the domestic economies of other countries via Sovereign Wealth Funds (SWF).

Sovereign Wealth Funds are state-owned investment funds composed of financial assets such as stocks, bonds, real estate, or other financial instruments funded by foreign exchange reserves.² SWFs continue to increase rapidly in quantity, size and reach, placing ownership of domestic industries in the hands of foreign governments. Recent media reporting and emerging academic discussion have raised concern that SWFs, by intention or incidentally, may pose threats to national security. This study investigates SWFs to assess if they pose a threat to Australia’s national security.

SWFs have existed since the 1950s; the first was the Kuwait Investment Office created in 1953.³ However, the size, quantity and reach of SWFs have increased dramatically over the past 15 years. In 1990 sovereign funds held at most \$500 billion,

the current total of SWF investments is an estimated US\$4.3 trillion.⁴ SWFs are estimated to grow to US\$12 trillion by 2015.⁵

Currently, more than 20 countries have SWFs, and half a dozen more have expressed an interest in establishing one. The holdings remain quite concentrated, with the top five funds accounting for about 70 percent of total assets.⁶ Over half of these assets are in the hands of countries that export significant amounts of oil and gas. In the case of China and Singapore, the nations do not export oil or gas, but maintain massive trade surpluses from the export of manufactured goods. The top ten owners of SWFs listed in order of the size of funds include: The United Arab Emirates (UAE), Norway, Singapore, Saudi Arabia, Kuwait, China, Libya, Qatar, Algeria, and the United States State (Alaska Permanent Fund Corporation).⁷ Many of these countries are not democracies, are not allies of Australia or the United States, and many of these nations have unclear national strategic interests. Appendix A provides a list of the countries holding the largest SWFs, listed in order of fund size.

SWFs as yet are not as large as institutional investors such as mutual and managed funds, but SWFs are already larger than private equity funds and hedge funds, and according to the U.S. treasury are set to grow at a much faster pace.⁸ Table One (below) provides a comparison of the total funds held by SWFs against other selected indicators (GDP, stock market capitalization, and Bank assets) to allow the relative size of SWFs to be identified.

Table 1. Selected Indicators of the size of Capital Markets, in Trillions of US Dollars. Allowing Size Comparison to SWFs.			
SWF world total funds held, as at October 2008, is approximately US\$4.3 Trillion, Projected to rise to US\$12 Trillion by 2015.			
Selected Indicators for Size Comparison (in Trillions of US Dollars)			
	GDP	Stock Market Capitalization	Bank Assets
World	\$48.2	\$51	\$70.9
North America	\$14.5	\$21	\$12.1
European Union	\$13.6	\$13	\$36.6
Australia	\$0.773	\$1.3	\$2.1

Source: IMF, Global Financial Stability Report (Oct 2007) 139. Australian data from www.asx.com.au.

SWFs can be defined and categorized in various ways; however, the central feature common to all SWFs is that they are investment vehicles controlled by a foreign government. However, this broad definition would include government owned ‘pension funds.’ Pension funds have not attracted the same level of suspicion as SWFs for several reasons. First, Pension funds are invested for a specific timeframe, with most due to cash out to recipients between 2010 and 2025.⁹ Second, despite holding a combined total of funds of approximately \$2.2 trillion,¹⁰ pension funds tend to be managed in smaller packages, and display greater transparency and regulation. Finally, pension funds are generally held by OECD countries, that is, by countries that are democracies and who have not displayed any suspicious or strategic intent in regards to the investment of their pension funds. Due to the factors outlined above, pension funds are generally considered to be different from SWFs. By contrast SWFs are: growing in size and are likely to be an enduring feature of global finance and geo-politics, they display less transparency and regulation than pension funds, and the majority of SWFs are controlled by nations who

are not democracies. As such, pension funds have not received the same level of concern as have SWFs within the literature reviewed. This study will focus upon SWFs and not pension funds; however, the same considerations raised by this study could apply to foreign pension funds in the event that they were used to purchase large controlling stakes in Australian companies.

For the purpose of this study a distinction is also made between ‘non-government foreign direct investments’ (FDI) and SWFs. FDI is defined as a private company from one country making a long-term investment in a controlling interest of a company in another country.¹¹ A controlling interest is defined by the IMF as owning 10% or more of the ordinary shares or voting power of an incorporated firm or its equivalent in an unincorporated firm. A percentage of foreign ownership less than 10% is known as a portfolio investment.¹² FDI often consists of a foreign parent company and a domestic affiliate which combine to form a multinational corporation. While there has been some concern about non-government FDI, the distinction between non-government FDI and SWF investment is that, in the case of SWFs the investor is a foreign government; while in the case of non-government FDI the investor is a private entity. The challenge for nations in the era of SWFs is to assess the national security impact of foreign government ownership of domestic industries, not simply ownership by foreign private companies. There is heightened concern that a foreign government may be investing not solely for profit, but in pursuit of its national strategic interests.

A final definition must be introduced, that of the state owned enterprise (SOE). The term SOE, is used interchangeably with the terms government owned corporation, or government business enterprise. The defining characteristics of an SOE are: they are

government owned, established to operate in commercial affairs, they may also have public policy objectives (think public utilities companies, and public transportation). Starting in the 1970s many nations began to privatize their SOEs, but all nations retain some SOEs. Today SOEs are most common in welfare-state nations, and socialist and communist nations.

The difference between a SWF and an SOE is that a SWF is a foreign government owned investment fund that buys a share of an existing company, while a SOE is an existing foreign company that is owned by the foreign government. The Government of the Peoples Republic of China (PRC) for example, retains approximately 60% ownership of Chinese companies. Many Chinese SOEs operate outside of China, including inside of Australia. While SWFs and SOEs are different, foreign SOEs do operate inside Australia and as such the actions and therefore the threats associated with SWFs can be extended to foreign SOEs. Thus, both SWFs and foreign SOEs should be considered together, as both SWFs and foreign SOEs that operate in Australia give a foreign government control of part of Australian industry; to ignore SOEs would ignore the true extent of foreign government ownership in Australia. As such, SWFs and SOE will be considered together for the purpose of this analysis.

Benefits of SWFs

SWFs are investments of a nations foreign exchange reserves. Large surplus foreign exchange reserves have been accumulated by nations that export significant quantities of oil and gas, or in the case of China, Singapore and the Republic of Korea, nations that export significant quantities of manufactured goods. Traditionally, these

nations either held the accumulated foreign currency as cash or invested the currency in government issued bonds in the nation from which the currency originated.

The holding of foreign exchange reserves is an advantage to a government as it allows the nation to have some effect on moderating its currency exchange rate to a desired level during times of turmoil, by selling or buying its currency, and to hold stabilization funds in the event of national crisis. However, beyond a certain level large quantities of foreign currency are not required for this purpose. The advantage of larger quantities of foreign exchange reserves then becomes the opportunity to hold on to finances for future national projects or for transfer to future generations. This is the case for many petroleum producing nations, who are aware that their petroleum resources will not last forever, these nations are choosing to hold investments for future generations. However, the traditional investments of holding foreign currency or investing in government issued bonds do not offer the preferred investment strategy to these nations, as exchange rate fluctuations can result in the eroding of the investment capital, and bond returns are not as high as the average rate of return offered by global stock markets. Thus, nations with significant foreign exchange reserves have chosen to establish SWFs to allow investment of surplus funds in investment products that offer a higher rate of return. SWFs also provide the investing nations with diversification across a broader number of investments; this allows mitigation of risk in the event that one investment product does not perform.

SWFs also offer benefits to the nations receiving the investment. SWFs facilitate the allocation of revenues from trade surpluses across nations, providing investment capital for economic growth and development. Thus, there is a dilemma for nations

receiving SWF investment, as a nation can benefit from SWF investment; however, nations also have an interest in controlling the level of foreign government ownership in domestic industries in order to avoid threats associated with too much foreign government control.

Threats and Concerns

About one-third of the total assets of SWFs are invested in Asian and Pacific countries, including Australia.¹³ In 2008 a significant portion of United States domestic industry has started to be purchased by foreign governments via SWFs as the effects of what has become known as the ‘credit crunch’ lowered the cost of U.S. publically listed companies, making U.S. companies attractive investment opportunities for SWFs. The 2008 global economic crisis may have resulted in some nations accepting SWF investment that would have otherwise faced a higher level of scrutiny.

There is a lack of transparency in regards to SWFs, as very few of them publish information about their assets or investment strategies.¹⁴ The Linaburg-Maduell Transparency Index was developed at the SWF Institute, as a method of rating transparency in respect to SWFs. The right hand column of the table at Appendix A shows this index, rating the transparency of the listed funds. This index uses Norway’s Government Pension Fund-Global as the standard for achieving the highest rating of ten, by adding ten essential principles that depict SWF transparency to the public.¹⁵ The principles used to create the rating are provided at Appendix A.

The danger raised by recent literature is that foreign ownership of certain companies may threaten national security. Several countries have raised concern in regards to SWF investment in defense industries, ports, infrastructure and utilities, media

companies, shipbuilding, aviation, banks and natural resources. The concern stems from the fact that as the owners of domestic companies, foreign governments gain voting rights in company shareholder meetings, and also the opportunity to elect preferred persons to the company's board of directors; in this way it is possible for the foreign government to bias company plans towards the strategic interests of the investing nation. Another concern is that foreign governments may gain access to sensitive technologies and rights to protected intellectual property and transfer that knowledge back to the investing nation. Other commentators have suggested that the investing nation may gain geopolitical influence and leverage over the country receiving investment. Concern is also raised for ideological reasons, as in many cases SWF investment equates to the cross-border nationalization of industries in capitalist nations by communist and authoritarian regimes this is viewed as a shifting away from the paradigm of free markets.

Furthermore, the most dangerous possibility raised by commentators is that in the event of future hostilities between the investing and invested countries, deliberate acts of economic sabotage may be used as a weapon of war. The chance of this worst case scenario may appear remote at first glance; however, it must be remembered that western nations, who have traditionally maintained ownership and control over the world's financial system, have used their financial power to freeze the finances of adversaries, such as terrorist groups, as well as, sanctions, embargos and financial manipulation to influence the strategic decisions of other nations. The freezing of an adversary's financial assets remains an economic strategy of many countries; including the United States,¹⁶ and Australia.¹⁷ If influence of the world financial system was to transfer to the hands of a foreign government then the financial system could be manipulated to the advantage of

that nation. This transfer of ownership has already begun: the Qatar Government owns 20% of the London Stock Exchange Corporation; the Chinese Government owns approx US\$1.4 trillion in United States Treasury bonds; the Chinese Government also owns nine percent of U.S. financial company Merrill-Lynch, ten percent of Barclays, and large shares of banks UBS, Citigroup, Fortis and Standard Chartered.¹⁸

Australian private industry has received significant investment from foreign governments via SWFs. SWF investment in Australia has mainly come from Singapore, China, Dubai, Kuwait and France. SWF investment has been directed into several Australian industries, including: energy, resources, infrastructure, utilities and defense industry. On 17 February 2008, the Australian Government released a set of principles outlining how Australia will regulate the investment of SWFs in domestic markets.¹⁹ This study will investigate if Australia's actions are warranted, and if they go far enough. The direct threat to Australia posed by SWFs cannot be discounted and requires assessment.

Continued vigilance and appropriate regulation, of the Australian domestic economy, may result in the mitigating of the direct threats of SWFs to Australia; however, developing nations within Australia's area of interest (the Asia Pacific region) may remain vulnerable to SWF investment and geo-political influence from investing foreign governments. Thus, SWF activity in developing nations in Australia's area of interest may continue to indirectly affect Australia's national interests. The indirect threat to Australia via SWF influence in developing nations is the hardest for Australia to control, as Australian policy to protect its own domestic economy does not restrict SWF investment within the region.

The developing countries of Asia Pacific region have attracted a significant portion of SWF investment.²⁰ These countries are in Australia's immediate area of strategic interest as outlined in *Australia's Foreign Policy and Trade White Paper 2003*,²¹ and identified further in the *Department of Defence White Paper 2000*,²² and *Australia's National Security: A Defence Update 2007*.²³ The developing nations of the Asia Pacific are in much greater need of foreign investment and are therefore less likely to regulate the level of foreign ownership. The foreign governments owning SWFs continue to gain influence over aspects of the domestic economies of countries in close proximity to Australia. Poor investment practices can have negative effects on the internal governance of developing nations that have been plagued by endemic economic, social and political problems. Chinese and Taiwanese SWF investment in the Asia Pacific region has been nicknamed "dollar diplomacy." Some commentators assess that China has strategic intentions to secure Chinese access to the plentiful natural resources of the region, while also promoting closer diplomatic ties between the host nation and China.²⁴ This economic influence over these countries provides the investing countries with influence and leverage over the politics and actions of these developing nations; but more importantly opaque and poorly managed foreign government investment can lead to corruption and instability in the region. This can create challenges to Australia's ongoing civil and military programs that aim to control corruption, and promote sustainable development and stability in the region.

Australia has a long standing concern over an 'arc of instability' which spans the region of Southeast Asia and the Southwest Pacific. Australia maintains a close interest in the economic and institutional development of the developing countries in this region.

Instability in the region has necessitated the deployment of Australian troops to several countries of the region over the past decade, including the Solomon Islands, Fiji, Tonga, East Timor, and Papua New Guinea / Bougainville. Today Australian troops remain deployed in East Timor and the Solomon Islands. The deployment of Australian troops to this region incurs an opportunity cost, as it limits government options to responding to other events, including contributing to Australia's bilateral or multilateral obligations.

The direct threat to Australia posed by SWFs cannot be discounted and requires ongoing assessment; however, once threats are identified Australian policy may be able to mitigate the threat of SWF investment in its own domestic economy. The indirect threat of SWFs via foreign government influence of developing countries in close proximity to Australia is the more likely scenario and one which Australia has limited means to control.

Research Question

The primary research question of this study is: are SWFs a threat to Australia's national security, either by direct foreign government investment in Australia's domestic economy, or by the influence of foreign government investment in the nations in the Asia Pacific region? In answering the primary research question this study addresses the following secondary questions.

Firstly, it investigates, how are SWFs investing in the strategic assets of other nations? And what are the threats posed by SWFs? The focus of this study is Australian national security; however, research also investigates what lessons can Australia learn from an analysis of SWF investment in other countries?

In analyzing SWFs, analysis turns to the question: is there appropriate regulation of foreign government investment via SWFs? After addressing the direct threats to Australia's domestic economy, the study assesses SWF investment in Australia's immediate area of interest, the Asia Pacific region. This area of research asks the question, what should Australia do to protect its national security interests in regards to SWF investment in developing nations within Australia's immediate areas of interest? This study also assesses if there is an opportunity for closer international cooperation as a result of SWFs? The conclusion of the study provides recommendations to Australian policy makers to ensure Australia is protected from strategic investment by foreign governments?

Assumptions

This study is conducted under the evidence based assumption that SWFs will continue to increase rapidly in size, number and reach as investment instruments for foreign governments to invest in the economies of other countries. This assumption is based on evidence that the current account surpluses of the countries concerned remain strong. SWFs are generated from a countries current account surplus and will become less important only if the countries concerned begin to run prolonged current account deficits.

Definition of Terms

Sovereign Wealth Fund (SWF):

A state-owned investment fund composed of financial assets such as stocks, bonds, real estate, or other financial instruments funded by government foreign exchange reserves.²⁵

State Owned Enterprise (SOE):

The term SOE, is used interchangeably with the terms government owned corporation, or government business enterprise. The defining characteristics of an SOE are: they are government owned companies, established to operate in commercial affairs, they may also have public policy objectives.

Foreign Direct Investment (FDI)

FDI is defined as a private company from one country making a long-term investment in a controlling interest of a company in another country. A controlling interest is defined by the IMF as owning 10% or more of the ordinary shares or voting power of an incorporated firm or its equivalent in an unincorporated firm. FDI often consists of a foreign parent company and a domestic affiliate which together form a multinational corporation.

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Portfolio Investment

A percentage of foreign ownership less than 10% is known as a portfolio investment.²⁷

Economic Security:

Safeguarding the structural integrity and prosperity-generating capabilities and interests of a political-economic entity in the context of various

externalized risks and threats that confront it in the international economic system’’.²⁸

Scope and Delimitations

This study focuses on threats to Australia’s national security; however, in assessing the threats to Australia it uses some examples of other nations experience in relation to SWFs. Recommendations are provided for the consideration of Australia policy makers; these recommendations are relevant to other nations as they continue to face unprecedented levels of foreign investment via SWFs.

This study does not devote significant space to an explanation of international investment markets. It only provides a short and broad summary of the origin of the wealth behind SWFs.

This study does not assume that SWFs are a threat; benefits and opportunities for closer international relations between countries are also investigated. This study is written at the unclassified level and does not disclose any information that is not approved for public release.

Significance of this Study

SWFs are a topic of rising interest and concern for governments in Australia, other nations, and international organizations, such as, the International Monetary Fund (IMF), the Organizations for Economic Cooperation and Development (OECD). A summary of recent international concern is provided in literature review at Chapter Two. As SWFs continue to grow and invest in Australia, foreign governments gain ownership of parts of Australian industry. It is important to investigate if the foreign government

ownership of Australian companies is a threat to Australia's national security, and if so, are there appropriate policies to mitigate the threat.

It is important for nations to identify any current or potential compromise of their national security posed by the ownership of national strategic assets and defense industries by a foreign government. Furthermore, SWFs are gaining influence over the domestic economies of developing nations in the Asia Pacific region. These developing nations are within Australia's immediate areas of interest and the effects of foreign government investment activity in these nations must be assessed.

The thesis put forward by this study is: SWF offer benefits, threats, and opportunities to international relations between nations. Australia may be able to mitigate direct threats to its domestic industries; however, SWF activity in developing nations in the Asia Pacific region is likely to continue to indirectly challenge Australia's national security interests.

¹ Charles Darwin: English naturalist, author, and theorist of the evolution of species by natural selection (1809-1882).

² SWF institute, <http://www.swfinstitute.org/swf.php> (accessed 20 Apr 2008).

³ Landon Thomas, "To Court or Shun and Wealth on Nations," *The New York Times*, 2 Apr 2008. H1.

⁴ Organization for Economic Cooperation and Development (OECD), <http://www.oecd.org/home/0,2987> (accessed 1 Apr 2008).

⁵ John Micklethwait (ed.), "Asset Backed Insecurity." *The Economist*. 19 Jan 2008. 79.

⁶ Organization for Economic Cooperation and Development (OECD). *International Investment of Sovereign Wealth Funds: Are new Rules Needed*. http://www.oecd.org/document/43/0,3343,fr_2649_201185_39641259_1_1_1_1,00.html (accessed 1 Apr 2008).

⁷ John Micklethwait (ed.), “Asset Backed Insecurity,” 78.

⁸ David McCormick, Under Secretary for International Affairs, testimony before the Joint Economic Committee , 13 Feb 2008, <http://www.ustreas.gov/press/releases/hp823.htm>. (accessed 20 Feb 2008).

⁹ OECD, *OECD Investment Committee Consultation on SWFs*, Trade Union Advisory Committee, 13 Dec 2007, 2.

¹⁰ Ibid. 3.

¹¹ United Nations Conference on Trade and Development, *Foreign Direct Investment* <http://www.unctad.org> (accessed 20 Feb 2008).

¹² International Monetary Fund (IMF), “Balance of Payments Manual,” fifth edition, Washington D.C.: IMF, 1993.

¹³ OECD. *OECD Investment Committee Consultation on SWFs*.

¹⁴ The National Bureau of Asian Research, *Understanding China’s New Sovereign Wealth Fund*, Jul 08. Prepared by Michael Cognato. Washington, DC. 10.

¹⁵ SWF Institute Inc., <http://www.swfinstitute.org/research/transparencyindex.php> (accessed 9 Nov 08).

¹⁶ United States Department of Defense, “Appendix A, Flexible Deterrent Options (FDOs),” Joint Publication 5-0. *Joint Operational Planning*. 26 Dec 2006. A-1.

¹⁷ Australian Department of Foreign Affairs and Trade, *Advancing The National Interest: Australia’s Foreign and Trade Policy White Paper*. Commonwealth of Australia, 2003. xi.

¹⁸ OECD. *OECD Investment Committee Consultation on SWFs*.

¹⁹ Treasurer’s Press Release 009/08, *Government improves Transparency of Foreign Investment Screening Process - Principles Guiding Consideration of Foreign Government Related Investment in Australia*. 17 Feb 08, <http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/009.htm&pageID=003&min=wms&Year=&DocType=0>, (accessed 20 Feb 2008).

²⁰ Ibid.

²¹ Australian Department of Foreign Affairs and Trade. *Advancing The National Interest: Australia's Foreign and Trade Policy White Paper*. Commonwealth of Australia, 2003. 23.

²² Australian Department of Defence. *White Paper 2000*, Canberra: Department of Defence, 2000.

²³ Australian Department of Defence. *Australia's National Security: A Defence Update 2007*. Department of Defence: Canberra. 2007.

²⁴ Congressional Research Service Report for Congress, *The Southwest Pacific: U.S. Interests and China's Growing influence*. 6 Jul 2007. Prepared by Thomas Lum and Bruce Vaughan. 1.

²⁵ SWF Institute. <http://www.swfinstitute.org> (accessed 20 Sep 2008).

²⁶ United Nations, *Foreign Direct Investment*, United Nations Conference on Trade and Development, <http://www.unctad.org> (accessed 30 Jun 2008).

²⁷ International Monetary Fund (IMF), 1993. *Balance of Payments Manual*, fifth edition, Washington, DC.

²⁸ Alan Collins (Ed.), *Contemporary Security Studies* (Oxford: Oxford University Press, 2007). 210.

CHAPTER 2

LITERATURE REVIEW

The explosive growth of SWFs has spurred intense discussions about the implications for the international financial system and concerns about national security. The debate over SWFs has been fueled in part by growing anxiety over globalization among developed nations. An ongoing assessment of the costs and benefits of SWFs, and issues of trade and investment liberalization have led to a variety of policy proposals for more rigorous SWF investment screening.

The primary research question of this study is: are sovereign wealth funds a threat to Australia's national security? Chapter One introduced the emergence of SWFs and identified that there is a suspicion that foreign governments may be using SWF to invest for strategic reasons rather than purely investing for profit. Two key threats were introduced: first, SWFs may invest directly in Australia's domestic economy in a way that undermines Australia's national security. Second, SWF investment in Australia's immediate area of interest, the Asia Pacific region, may indirectly affect Australia's national security interests. This chapter outlines the existing body of literature related to SWFs. It explains the recent, wide and somewhat alarmist coverage that SWFs have received in mainstream newspapers and journals. This is followed by reference to academic studies and books related to issues of globalization, providing a context for understanding international relations, and the emergence of SWFs. This chapter introduces research related to SWFs, Australian strategic policy and foreign investment policy. Literature related to international relations theory, and economic security is outlined to provide a theoretical framework for subsequent discussion within the study.

Literature related to foreign government economic influence in the South West Pacific is outlined. The threats raised in the existing literature are categorized to form a framework for assessment in Chapter Four. This chapter identifies key themes of the existing literature and identifies gaps in knowledge related to SWFs. Finally, this chapter identifies why the research to be undertaken by this study is needed, and how the focus of this study supplements the existing body of knowledge.

SWFs: Rising Interest and Concern

The first use of the term SWF was by Andrew Rozanov, in an article titled “Who holds the Wealth of Nations?” in May 2005.¹ Since the coining of the term, newspapers and journals from all nations have begun to provide somewhat alarmist coverage of the actions of SWFs. SWFs have been a topic of increasing interest as countries are confronted with an unprecedented and increasing level of investment by foreign governments. Debate has begun in journals and newspapers regarding the potential compromise of national security resulting from SWFs. Mainstream Australian and international newspapers and magazines have recently joined the discussion.

The principle focus of Australian newspaper commentary has been the action of the Chinese Government to purchase large shares of the Australian resource industry. Australian commentary increased in February 2008, following the Chinese SOE Chinalco’s purchase of a 9% stake in giant mining company Rio Tinto for AU\$15 billion, a move that threatened to block the takeover of Rio Tinto by its peer BHP.² It is considered to be this action that prompted the Australian Treasurer’s release of the six *Principles Guiding Consideration of Foreign Government Related Investment in Australia*.³

The Chinese Government had already gained approval, in January 2008, for 100% ownership of iron ore miner Midwest Iron, in Geraldton, Western Australia.⁴ Since then, the Australian Foreign Investment and Review Board (FIRB) took unprecedented action in placing a 90 day delay on the consideration of Chinese SOE Sinosteel's application for a 49% takeover of Murchison Metals, an iron ore prospector in the Midwest region of Western Australia. This came after the Treasurer initially ruled that a 100% stake in Murchison would not be allowed, prompting the application to be adjusted to 49% ownership.⁵

There has been concern that the Chinese Government is gaining too much influence over resource industry operations in Australia. On 4 July 2008, the Australian Treasurer stated that since he took the position in November 2007, he had approved AU\$30 billion in Chinese Government investment in Australia, at a rate of approval of one application every nine days.⁶ Australian trade with China has soared to AU\$60 billion per year, making it Australia's largest trading partner, accounting for 23% of total trade. Chinese investment in Australia has been low until quite recently, but has grown from AU\$3.7 billion in 2006, to AU\$10 billion in 2007, and for 2008 is already in excess of AU\$30 billion. This gives the Chinese Government five percent of all foreign investment in Australia (including both government and non-government foreign investment).⁷ Some commentators have cautioned that the action of the Australian Government to regulate foreign government investment risks discouraging investment and sending needed investment capital elsewhere, and that Australia should avoid establishing protectionist policies.⁸

Concern regarding SWFs is not limited to any one region: Australia, New Zealand, the United States, the European Union, Russia and Africa are all expressing caution in regards to increased foreign government investment in their nation's domestic industries. *The Economist* magazine recognized the importance of the SWF threat with a front page article titled "Invasion of the Sovereign Wealth Funds" on 19 Jan 2008.⁹ *The New York Times* grasped the importance of the threat of SWFs with a special-lift-out-section on 2 April 2008.¹⁰ A number of online websites have been established to collate information on SWFs. The website www.swfradar.com provides daily updates on international print media articles related to SWFs. The website www.swfinstitute.org provides online commentary and links to SWF related information. Much of the discussion in the international media has been commentary on the reaction of the governments of nations receiving the investment, concerned private companies and individuals, as well as, statements by the investing governments explaining their actions.

International organizations have entered the debate as western countries have raised their concerns to the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD), and the G7. The OECD, with the participation of the IMF, organized a conference titled "Sovereign Wealth Funds in the Global Investment Landscape: Building Trust" which was held in London on 31 March 2008. This meeting provided an opportunity for representatives of SWFs, private financial institutions and recipient governments to share views on what steps SWFs and recipient governments can take to build mutual confidence and trust. SWFs were also a topic of discussion at the G7 meeting held in New York, during the first week of April 2008. The OECD, IMF and G7 provide a valuable and independent perspective as each

organization is principally concerned with maintaining free markets and avoiding protectionism, and are not directly threatened by the actions of SWFs.¹¹ A “Sovereign Wealth Funds Summit” was held in Sydney 25-26 June 2008. This summit aimed to provide awareness of the impact of SWFs on the Australian economy, participants included Australian academics and business leaders. An “International Working Group of Sovereign Wealth Funds” was held in Santiago, Chile on 20 September 2008, bringing together the owners of SWF and the IMF, G7 and OECD. The working group discussed a set of voluntary “Generally Accepted Principles and Practices for the conduct for SWFs”, to help foster trust and confidence between SWFs, their originating countries, and the recipient countries. These became known as the “Santiago Principles” and were then presented to a meeting of the IMF in Washington D.C. on 11 October 2008. The Working Group proposed to establish a standing group of SWFs that would keep the principles under review, monitor implementation, and continue dialogue with recipient countries.¹²

Books, Academic Works and Institutional Research

General

A plethora of academic works and books addressing the effects of globalization and the changing international trade balance have been published in recent years. Commentators include: Samuel P. Huntington, author of *The Clash of Civilizations and the Remaking of the World Order*;¹³ Lionel Barber author of *Jihad vs McWorld*;¹⁴ and Thomas L. Friedman author of *The World is Flat, and the Lexus and the Olive Tree: Understanding Globalization*.¹⁵ Much of the debate, in the books, has been captured by related articles by each author in the pages of the journals such as *Foreign Affairs* or in editorials in *The New York Times*. These authors cover the rising wealth of many of the

countries possessing SWFs, changes in international trade, and changes in the international balance of power.

Thomas Freidman's contribution has an interesting application to the rise of SWFs. Freidman used the metaphor of a "golden straightjacket" to describe the economic rules that the western world places on other nations via institutions such as the IMF, and the World Bank. Freidman's suggestion is that this economic golden straightjacket requires other nations to confirm to market principles, reduce corruption, promote human rights, democracy and other western ideals as a requirement to participate in the global economic system; to date this golden straightjacket has supported western interests of spreading democracy and the adoption market principles throughout many parts of the world.¹⁶ It is possible that the emergence of SWFs may offer an alternate to the western golden straightjacket. This is already evident in Africa, South America, and South West Pacific, where China is offering SWF investment (and foreign aid), without asking for the same social compliance that western nations request. Unconditional SWF investment by nations such as China may compete with western interests, as the developing nations are not encouraged to adopt western principles. This idea is investigate further in the second half of Chapter Four, in analyzing SWF activity in Australia's immediate area of interest, the Asia Pacific region.

The new era of globalization and the reach of foreign investment have changed traditional models of how international business is understood. In *The Work of Nations*, former U.S. Secretary of Labor, Robert Reich, comments on the effect of globalization and foreign investment. He proposes that in the new era, companies are no longer committed to their home country and that all countries must compete for foreign

investment.¹⁷ Management consultant Kenichi Ohmae argues that the forces of globalization make it less useful to talk about national economies, and that the rise of industrial clusters would make regional economies a more accurate tool for understanding the global economic landscape.¹⁸ In *Comparative Advantage Among Nations*, business strategist Michael Porter, contends that countries can maintain some isolation from the impacts of globalization, but only by maintaining control of and building on key national advantages.¹⁹ David Baron argues that the forces of competition are forcing companies to enter into agreements with governments and non-governmental organizations, international organizations whose actions and decisions impact company goals. With these ideas in mind Joseph Nye notes that, some theorists have suggested that future international relations will revolve around geo-economics rather than geo-politics, whereby nations and non-state actors will use economic instruments to influence global politics.²⁰ Many commentators agree that the international business environment is extremely complex, continues to change rapidly, and poses many challenges for governments.²¹

A February 2007 study by Terrence Guay, *Globalization and its implications for the Defense Industrial Base*, for the U.S. Strategic Studies Institute, finds that globalization has blurred the distinction between a domestic and foreign defense company. He concludes that foreign ownership of the defense industry is a practical outcome of the globalization of capital, production, trade, technology and labor. Guay claims that policies that aim to keep the artificial distinction, of domestic and foreign defense companies, are not helping the defense industry obtain the best technology, national security or economic competitiveness.²²

The book *Australia's Position in the Global Economy*, by David Meredith and Barrie Dyster, provides an introduction to Australia's economic evolution over the twentieth century and into the age of globalization. It covers the role that foreign investment played in developing several key Australian industries including the energy and resources sector in the 1970 and 1980's. This book provides a relevant background to understanding the advantages of foreign investment to Australian economic development.²³

Research Covering SWFs.

Academic works covering SWFs have started to emerge in the last year, with coverage increasing in the middle of 2008. Ashby Monk, a research associate at the Centre for Employment, Work and Finance at Oxford University Centre for the Environment, provides an analysis of SWFs in his paper *Recasting the Sovereign Wealth Fund Debate: Organizational Legitimacy, Institutional Governance and Geopolitics*. His paper claims that the relevance of SWFs to the evolving economic, political and financial landscape cannot be overstated. He finds that SWFs challenge the notions and practice of governance in traditional financial institutions.²⁴ Another academic paper *Sovereigns as Shareholders*, published in North Carolina Law Review, is provided by Paul Rose, Assistant Professor of Law, Ohio State University. Rose investigates the idea that SWFs may be used for political purposes. He claims the risks associated with SWFs are considerable, but also identifies the mitigating effect of a number of regulatory, economic and political factors. He identifies that these mitigating factors exist in the United States; however, he raises concern in regards to SWF investment in other countries with looser

regulation, claiming that U.S. interests may be harmed by politically motivated SWF investment in other countries.²⁵

Christopher Balding, of University of California- Irvine, contributes to the debate in his paper *A Portfolio Analysis of Sovereign Wealth Funds*. He assesses SWFs to be more benign. He concludes that, to date SWFs have acted as rational, economically driven investors, diversifying investment by asset class and geographical region; and that data does not currently support measures to restrict cross border investment, though countries would be wise to follow the development of SWFs.²⁶ U.S. national security consultant and author Thomas P.M. Barnett, has provided regular commentary of the rise of SWFs, via contribution to several journals and via his blog site, <http://www.thomaspmbarnett.com>, Barnett states that SWFs are new and large, and as such, we don't have a significant past experience to allow for the discounting of perceived risk.²⁷

Felix Chang and Jonathan Goldman's article, *Meddling in the Markets: Foreign Manipulation*, presents an analysis of how a nation may use financial manipulation as a strategic weapon. The example used by Chang and Goldman is financial manipulation of the United States by China. The case study reveals how such an attack is possible as a result of China holding significant investment assets in the United States, U.S. treasury bonds and U.S. foreign exchange reserves. The article identifies that such an attack would also produce economic hardship in China, but Chang claims that the affect on China would be commensurate to, or less than, the losses a country would have to expect by using more traditional means of warfare. As such, the article concludes that economic

manipulation to impose a financial crisis remains a feasible course of action, for a nation with the means to accomplish it.²⁸

The U.S. Congress Research Service's (CRS's) Report for Congress, titled *China's Sovereign Wealth Fund*, of 22 January 2008, provides information of the China Investment Corporation (CIC) SWF that was initiated on 29 September 2007.²⁹ The CRS report identifies that the CIC may be aiming to shift most of its \$1.5 trillion in U.S. treasury debt into the fund. The report raises concern that such a move would put upward pressure on U.S. interest rates at a time when the U.S. Federal Reserve is striving to keep interest rate low to prevent a possible economic recession. The report assist is categorizing some of the threats posed by SWFs, identifying there have been concern over Chinese aims to secure energy resources, purchase strategic assets for geo-political purposes, and to obtain access to sensitive technology and information. The CRS report recommends U.S. regulatory changes to: require access to audited CIC financial statements; restrict the percentage of CIC ownership of U.S. companies; restrictions on voting shares, banning CIC electing preferred members to the board of directors of U.S. Companies. It is the CIC that has invested in several companies within Australia's resource industry. This fund is also an investment partner of Chinese state owned company Chinalco, which purchased a nine percent stake in resource company Rio Tinto, a move that could block the pending takeover of Rio Tinto by resource giant BHP.³⁰

Another piece of useful research, *Understanding China's New Sovereign Wealth Fund* (Jul 08), comes from the U.S. National Bureau of Asian Research. This research examines the establishment, management, and investment decisions to date of the CIC, analyzes causes of concern and identifies opportunities. It finds "as yet, there is little

evidence to support worries that CIC will pose a national security threat or will engage in investments meant to serve China's broader strategic priorities." However, it warns of "real causes of concern that CIC will abet financial corruption or provide unfair advantages to Chinese state companies." It also identifies the benefits of recycling Chinese trade surpluses to other nations for use as investment capital, further identifying that this could accelerate liberal reform of China's domestic economy.³¹ This research further shapes an understanding of how to categorize the threats of SWFs, referring to threats of company influence, strategic influence, access to sensitive technologies, and ideological concern in regards to shifts away from market principles.³²

Deutsche bank research, of 10 September 2008, provides quantitative information on SWFs, also identifying potential implications for market instability. The bank's research suggests public policy should be directed to the key principles of: Open markets, with political intervention for reasons of national security as a last resort; Reciprocity, SWF nations allowing investment inflows; and increased transparency.³³

Quantitative information of SWFs is available from several sources. A number of banks have provided studies that compile information on SWFs, including Morgan Stanley. The SWF institute provides statistics on its website www.swfinstitute.org, Australian online magazine *The Mayne Report* has collated a list of SWF investments in Australia, from a review of press releases and stock exchange announcement, and makes the point that it would be a lot easier if the Treasurer's office provided a complete list of SWF investment.³⁴ The list provided by *The Mayne Report*, supplemented with other reports and newspaper articles provides a basis for analysis of the extent of SWF investment in Australia. Some commentary in *The Mayne Report* is observed to be

sensationalist at times; however, the data presented is highly valuable. The Australian Treasury's Macroeconomic Group, provides a paper *A Few Sovereigns More: The Rise of Sovereign Wealth Funds*.³⁵ This short paper calls on the international community to manage the risks while avoiding protectionism of domestic industries, it suggest regulation should be investigated and that the IMF should be the lead international agency. On the 24 June 2008, a background note was prepared for the Members and Senators of the Australian Parliament to describe the responsibilities and powers of the Australian Foreign Investment Review Board (FIRB) regarding the takeovers of Australian companies by overseas companies. The note also covers the emerging issues associated with SWFs.³⁶

The International Monetary Fund (IMF) at the request of concerned nations published a report on SWFs, titled *Sovereign Wealth Funds: A Work Agenda*, on 29 February 2008.³⁷ The IMF report covers: concern raised by SWF investing nations and recipient nations, effect on macroeconomics, calls for regulation, and concerns in regards to national security. The report collates know information and proposes an internal agenda for an IMF working group in partnership with the Organization for Economic Cooperation and Development (OECD) to continue analysis of SWFs.

Academic works and studies by Australian and international agencies have begun to frame the problem of SWFs. There are several opinions of SWFs; however, all commentators agree that there are both threats and opportunities. All commentators recommend further study and most identify the need for some form of mitigation or regulation of the risks, be it regulation by individual governments or by an international organization such as the IMF. The threats raised by commentators can be categorized into

four areas. This categorization provides a framework for analysis in Chapter Four, including: 1) Influence of company and industry activity towards the strategic interests of the investing nations. This includes foreign governments gain voting rights in company shareholder meetings, and also the opportunity to elect preferred persons to the company's board of directors. 2) Access to sensitive technologies and rights to protected intellectual property. 3) Geo-political influence and leverage over the country receiving investment. 4) Ideological concern, over the cross-boarder nationalization of industries in capitalist nations by communist and authoritarian regimes, and impact of the free markets paradigm.

International Relations Theory

International relations theorists do not address SWFs directly, but provide a framework for understanding relations between nations. Realist theory, championed by Machiavelli, Thomas Hobbes, and contemporary authors such as Joseph Greico, predicts that conflict should be the norm in international relations.³⁸ Meanwhile, liberal theory, founded by Adam Smith and Immanuel Kant, argues that economic interdependence lowers the likelihood of war by increasing the value of trading over the alternative of aggression. Stephen Krasner's regime theory proposes that cooperation is possible when countries share common interests.³⁹ Neoliberal's Joseph Nye and Robert Keohane's interdependence theory promotes the idea that countries that trade with each other are less likely to fight each other.⁴⁰

More recently, a group of theorists labeled 'constructivists' have emerged. Constructivists emphasize the importance of ideas and culture, and point out that concepts such as 'nation' and 'sovereignty' are socially constructed and change over time

and are not a permanent reality.⁴¹ A recent independent theorist who could be labeled a constructivist is Dale Copeland. Copeland's 1996 article "Economic Interdependence and War: A theory of Trade Expectations" provides a valuable analysis of international relations theory in regards to economic interdependence.⁴² Copeland's article proposed a new theory of trade expectations, by introducing the new variable of a nation's expectation of future trade. Copeland suggests that both liberal and realist theories have been unsatisfactory in explaining the causes of the two World Wars. The theory of future trade expectation, helps resolve this problem, it fuses the liberal insight that the benefits of trade give states an incentive to avoid war, with the realist view that the potential costs of being cut off from global commerce can push states to war to secure vital resources. The theory proposes that interdependence can foster peace, as liberals argue, but only when states expect that the benefits of trade will be high for the foreseeable future. If highly interdependent states expectations of future trade are low, realist theory is likely to dominate and even the most highly interdependent states will initiate war, for fear of losing the economic wealth that supports their long-term prosperity and security. In short, trade expectations theory proposes that high interdependence can be either peace-inducing or war-inducing, depending on the expectations of future trade. Copeland's theory provides a valuable tool for analyzing the threats and opportunities of SWFs. The application of future trade expectation to SWFs is investigated in Chapter Four.

Economic Security and Economic Warfare

Classical economic theorist Adam Smith, the author of *The Wealth of Nations* (1909) and the father of economics, referred to his discipline as "political economy." Smith understood that the word "economy" without the adjective "political" did not

describe reality.⁴³ The economics of a nation is linked to its national politics and its national security policy.

Security studies, a sub-discipline of international relations, has been an evolving discipline. In the twenty-first century, the discipline of security studies has received a thorough review of its core assumptions as globalization and transnational terrorism present new security challenges. Security is an extremely broad subject that includes “any threats to a nation’s survival.”⁴⁴ Economic security is a component of national security. A study of SWFs requires an understanding of the concept “economic security”. The book *Contemporary Security Studies*, which is a preferred resource of several universities’ graduate strategic studies programs, includes a chapter on economic security by Christopher Dent. Dent identifies that “economic security is an increasingly discussed but still a relatively under-theorized concept”, also identifying that scholars have approached economic security from various disciplinary perspective. Dent defines economic security as “safeguarding the structural integrity and prosperity-generating capabilities and interests of a political-economic entity in the context of various externalized risks and threats that confront it in the international economic system”.⁴⁵ Economic security involves the maintenance of a given level of prosperity and state power through access to resources, finance and markets; while minimizing threats and maximizing opportunity. Dent identifies eight components (what he calls “objective typologies”) of economic security: “supply security, market access security, finance-credit security, techno-industrial access security, socio-economic paradigm security, trans-border community security, systemic security, and alliance security.” These eight components refer to what a nation requires to engage in international trade and commerce in the modern age, while

safeguarding the economic prosperity of its citizens. In addition, this work distinguishes the ‘economics-security nexus’, that is, the requirement for a nation to maintain a strong economy in order to fund and build military capability, and economic choices made to pursue the nation’s strategic interests. This categorization of the components of economic security provides a valuable framework for understanding the aspects of a nation’s economy that must be safeguarded from external threats – including the threats of SWFs. The eight components of economic security identified by Dent, will be used in Chapter Four as part of the analysis of the threats that SWFs may pose to Australia.

Numerous works cover the topic of economic warfare, explaining how nations deploy trade sanctions, blockades and financial restrictions as political weapons. R. Thomas Naylor’s analysis in his book “Economic Warfare: Sanctions, Embargo Busting, and Their Human Cost,” suggests that economic warfare measures seldom work, while often causing unintentional harm to both the country imposing the sanctions and the innocent population of the sanctioned country.⁴⁶ Other academics have identified instances when economic and financial manipulation played a significant role in the achievement of a nation’s strategic aims. An example, presented by Diane Kunz in *The Economic Diplomacy of the Suez Crisis*, reveals the effectiveness of United States financial manipulation via the selling of foreign exchange reserves to devalue the currencies of the United Kingdom, France and Israel during the 1956 Suez crisis. This action quickly devalued the currencies of each nation and had the effect of pressuring the participants to withdrawal forces from Egypt.⁴⁷ Another example of effective economic coercion is the 1973 Arab Oil Embargo, in which the Arab members of the Organization of Petroleum Exporting Countries (OPEC) stopped the sale of petroleum to the nations

who had supported Israel in the 1973 war against Arab nations. This action gave the Arab nations significant bargaining power and changed several westerns nations pro-Israel stance to a more neutral position.⁴⁸

Unrestricted Warfare (1999) authored by two China's People's Liberation Army Colonels raises the potential for new financial instruments to be used as weapon. This book provides evidence that China is well advanced in understanding the wide array of national tools available in the age of global finance. It discusses the manipulation of stock markets as a means of waging war in the future.⁴⁹

Thus, there are historic examples of the use of financial and trade manipulation being used for geo-political influence, as well as studies that investigate the potential to use new financial instruments to exert strategic pressure. Against this background the concerns about threats from SWFs gain increased credibility.

China

Of course, the reference *Unrestricted Warfare* outlined above is simply a study by a couple of military professionals. A broader investigation is required to identify patterns in China's strategic policy and activities, many recent reports on China are available. The report by Jain Zhang, *Building 'a Harmonious World'?: Chinese Perceptions of Regional Order and Implications for Australia* (Jun 2007), prepared for the Australian Policy Institute offers valuable analysis. It investigates several recent statements and policy publications by the Chinese Government; Including, China's 2005 White Paper, titled *China's Peaceful Development Road*, which declared "building a harmonious world," as the "lofty goal of China."⁵⁰ Jian reports that the Chinese meaning of 'harmony' was best

described by the then Chinese President Zemin in a foreign policy speech in the United States in 2002, the Chinese President stated:

*Harmony is not sameness; reserving difference without coming into conflict. Harmony promotes co-existence and co-prosperity, while difference fosters mutual complementarity and mutual support. Harmony-with-difference is an important principle in the development of all social relationships and in guiding peoples conduct and behavior. Indeed, it is the essential factor of the harmonious development of all civilizations.*⁵¹

Jian finds that “despite its confusion cloth, the [Chinese] notion of harmonious world still reflects an essentially Westphalian notion of international relations.”⁵² Further, insight to Chinese strategic policy came from the current Chinese President Hu, during his 2005 speech to the United Nations in which he listed the following four ways to build a harmonious world: Upholding multilateralism to realize common security, promoting mutually beneficial economic cooperation, respecting cultural, social and political diversity, and maintaining the United Nations authority and efficacy.⁵³

Jain concludes that China’s increasingly cooperative policy approach, and reference to regional stability and economic development serve Australia’s interests in the Asia Pacific region. While on the other hand, Jain observes China’s vision of ‘a harmonious world’ and its rising regional prominence may mean that a future China dominated regional order may be based on different norms and values from those currently espoused by western nations. Jain warns, China’s inclination to stress the importance of sovereignty and non-interference in regional affairs during economic engagement, may push human rights, and good governance off the agenda; presenting challenges for Australian policy in the region.

Several other studies make a similar conclusion, amongst them *The Rise of China in Asia: Security Implications* (2002),⁵⁴ and *Does the PRC have a Grand Strategy of*

Hegemony? (2005).⁵⁵ The study *Chinese Strategic Power: Myths, Intent and Projections* (2007), by Ralph Sawyer provides a thorough review of Chinese strategic policy from ancient times to modern. He observes that the China's enormous need to resources will place huge demands on the world in regards to resource competition. He finds a level of secrecy in regards to Chinese policies and practices, and that this often results in disproportional importance being given to the reports that are covered in the open-source media. He claims this makes it difficult to project Chinese intentions, and creates unconfirmed suspicion.⁵⁶

Foreign Influence in the Southwest Pacific

Literature from government departments and academics in Australia and in the United States outlines the concern, in regard to foreign government economic influence in the Asia Pacific region, and specifically the Southwest Pacific. Australian literature includes policy statements by the Australian Government and research by Australian academics. Much of the Australian literature is available online at www.apo.org.au, www.lowyinstitute.com, or from governmental department websites www.defence.gov.au, and www.dfat.gov.au. The U.S. Congressional Research Service has prepared several *Report's for Congress*, related to the Southwest Pacific; the most significant compares U.S. and Australian interests in the region, to the interests of China and Taiwan.⁵⁷ Commentary of Asia Pacific geo-politics can also be found in mainstream Australian and international journals. Research related to Chinese and Taiwanese economic influence in the region is also available from the private intelligence company Strategic Forecasting Incorporated.⁵⁸

A review of the literature, in regards to the Southwest Pacific, identifies that the Southwest Pacific is strategically important to Australia and several other nations. As a sign of its strategic importance the Southwest Pacific, per capita, receives among the highest rates of foreign aid in the world.⁵⁹ The literature identifies that Australia, New Zealand and the United States share mutual strategic interests of promoting economic development, political stability and controlling civil unrest; in order to prevent corruption, transnational crime and the harboring of terrorist cells. Since World War II, Australia, New Zealand and the United States have also sought to prevent any potential adversary from gaining a strategic posture in the South Pacific that could challenge their security, including military basing at ports and airfields, which proved their geographical significance during the Second World War.

The literature identifies the growing influence of the People's Republic of China (PRC) and Taiwan in the Southwest Pacific. The PRC and Taiwan have both become a growing force in the Southwest Pacific. They have both extended their diplomatic and commercial presence, including via the use of SWF investment, in order to garner political and economic influence in relation to the recognition of Taiwan; while also aiming to gain political leverage with the United States and its Allies, and to access raw materials. In return for aid and SWF investment the PRC and Taiwan demand support for diplomatic objectives (a vote in the United Nations General Assembly on the question of Taiwan independence). Some analysts argue that this "dollar diplomacy" (large amounts of unconditional aid in exchange for support on international issues) may exacerbate corruption and political instability in the recipient countries while not leading to broader economic development.⁶⁰

Australian National Strategic Policy Documents

National strategic policy documents of Australia are yet to address the specific threat of SWFs; however, policy documents do refer more broadly to the threats of economic power and the increasing financial wealth of emerging countries. *Australia's Foreign Policy and Trade White Paper 2003*,⁶¹ the *Department of Defence White Paper 2000*,⁶² and *Australia's National Security: A Defence Update 2007*,⁶³ do not refer to the threats of SWFs; however, they do recognize that “globalization is a trend shaping the strategic environment.”⁶⁴ *The White Paper* recognizes that, “Australian industry is a vital component of Defense capability, both through its direct contribution to the development and acquisition of new capabilities and through its role in the national support base.”⁶⁵ The importance of Australia's defense industrial base to national security is echoed again in *The Defence Capability Plan: Public Version 2006-2016*; *The Defence and Industry Policy Statement 2007* and *The Defence Procurement Review 2003*. These documents identify that Australian industry is of national strategic importance.

On 17 February 2008, the Australian Treasurer, the honorable Wayne Swan, released a new policy document titled *Principles Guiding Consideration of Foreign Government Related Investment in Australia*; this was the first public release of Australian policy to regulate foreign government investment in Australia.⁶⁶ This public release was in response to increased public concern of the investment intentions of SWFs. The policy builds on the principles of the Australian *Foreign Takeovers Act 1975*, and the *Foreign Takeovers Amendment Act 1976*. On the 24 June 2008, a background note was prepared for the Members and Senators of the Australian Parliament to describe the responsibilities and powers of the Australian Foreign Investment Review Board (FIRB)

regarding the takeovers of Australian companies by overseas companies. The note also covers the emerging issues associated with SWFs.⁶⁷

The Treasurer's new principles and the *Foreign Takeovers Acts* provide evidence of the Australian governments concern for the protection of national industries from foreign government ownership. Australia, was the first nation to release a set of principles in regards to SWF, since then Germany has release a policy statement and several other nations have begun discussion in regards to policy adjustments.

Literature Review Summary

The increasing size, quantity and reach of SWFs have attracted the attention of the worlds newspapers and journals. The rising wealth of nations with consistent trade surpluses has been a topic of discussion in books on globalization and the changing international balance of power. Academic works and studies by Australian and international agencies have begun to frame the problem of SWFs. There are several opinions of SWFs; however, all commentators agree that there are both threats and opportunities. All commentators recommend further study and most identify the need for some form of regulation of the risks.

The literature reviewed, identifies that many assertions have been made about various threats in regards to foreign government control of domestic industries. However, there has been limited detail on the specific nature of threats. This study helps fill this gap by providing an analysis of SWF threats to Australia's national security. Generally speaking the literature addressing threats related to SWFs can be placed into four categories:

- 1) Influence of company and industry activity towards the strategic interests of the

investing nations.

2) Access to sensitive technologies.

3) Geo-political influence.

4) Ideological concern, and shift in the free market economic paradigm.

These four threat categories will form a framework for analysis in Chapter Four.

Within the threat category framework, the components of economic security that Australia must protect are investigated. Christopher Dents components of economic security provide a checklist for investigation: supply security, market access security, finance-credit security, techno-industrial access security, socio-economic paradigm security, trans-border community security, systemic security, and alliance security. In addition, Dent distinguishes the ‘economics-security nexus’, that is, the requirement for a nation to maintain a strong economy in order to fund and build military capability, and economic choices made to pursue the nation’s strategic interests.

This study draws on the existing body of knowledge and investigates threats to Australia’s national security related to SWFs. The next chapter will outline the research methodology utilized in the conduct of this study.

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CHAPTER 3

RESEARCH METHODOLOGY

Background

This study evaluates the emergence of SWFs and investigates if the new economic power being wheeled by foreign governments has the potential to threaten Australia's national security. Chapter One introduced SWFs, explaining the origin of SWFs, and their recent expansion in size and reach, identify the holders of SWFs, and outlined the benefits that SWFs offer to the investing nations, as well as the apparent benefits to the nations receiving investment. The definition of SWFs was distinguished from pension funds and from non-government foreign direct investment; it was explained that pension funds and non-government foreign direct investment are not the focus of this study. Sovereign Owned Enterprises (SOEs) were introduced; it was identified that foreign SOEs that operate inside Australia should be considered alongside SWFs, as both SWFs and SOEs place ownership of parts of Australian industries in the hands of foreign governments. It was explained that SWF lack transparency and regulation, and that a number of nations have raised concern that SWFs may be investing not solely for profit, but may have strategic objectives. As such, SWFs may pose a threat to Australia's national security. Two key threats are identified. First, SWFs may invest directly in Australia's domestic economy in a way that undermines Australia's national security. Second, with continued vigilance Australian regulatory policy may be able to mitigate SWF direct threats to Australia; however, SWF investment in Australia's immediate area of interest, the Asia Pacific region, may continue to indirectly affect Australia's national security interests.

Chapter Two reviewed the existing body of literature that relates to SWFs, including: Newspapers and journals; Australian government research, research from other nations, from international agencies, and from commercial financial institutions. The literature reviewed included literature related to wider subjects, of relevance to an analysis of the threats of SWFs to Australia's national security, including: Australian strategic policy, Australian foreign investment policy, international relations theory, globalization, the Asia Pacific region, and economic security theory.

The literature reviewed, highlighted the threats and concerns raised by Australia government officials, Australian private industry, and the Australian public; as well as concerns raised by government and private parties in the United States, the European Union; and international agencies, such as the IMF, G7 and OECD. The literature provided a framework of policy and theory for use in the analysis, including: Australian national strategic policy documents, international relations theory, and economic security theory.

Research Methodology

This chapter outlines the research methodology utilized for the conduct of this study. The study employs a mix of both qualitative and quantitative analysis methodology. The primary research question is: are SWFs a threat to Australia's national security, either by direct foreign government investment in Australia's domestic economy, or by the influence of foreign government investment in the nations in the Asia Pacific region? The research is divided into two main parts.

Direct Threats to Australia's National Security

The first part investigates that SWFs may invest directly in Australian national strategic assets in a way that undermines Australia's national security. In Chapter Two, a review of the literature by the author grouped the threats related to SWFs into four categories. The methodology for analyzing direct threats involves a review of each of the four threat categories.

- 1) Influence of company and industry activity towards the strategic interests of the investing nations. This includes foreign governments gain voting rights in company shareholder meetings, and also the opportunity to elect preferred persons to the company's board of directors.
- 2) Access to sensitive technologies and threats to defense industry.
- 3) Geo-political influence and leverage over the country receiving investment.
- 4) Ideological concern, over the cross-boarder nationalization of industries in capitalist nations by communist and authoritarian regimes, and shift in the free market economic paradigm.

The extent of SWF investment in Australia industry is analyzed by identifying the foreign governments invested in Australia via SWFs, and the industries in which they are invested. Analysis includes all known SWF investment, across all Australian industries using information from the literature reviewed. At this point in time the Australia Treasury does not provide a list of foreign government investment in Australia. The literature review referred to collated information from various sources producing the

table at Appendix B, “Foreign Government Investment in Australia.” The table displays a list of SWF and SOE investment in Australia, identifying the foreign governments making the investment and the Australian company and industry receiving the investment. The list also includes a list of pending and blocked SWF investment activity in Australia. The data identifies that the following foreign governments have investments in Australian industry:

- 1) Singapore.
- 2) The Peoples Republic of China,
- 3) Dubai, United Arab Emirates,
- 4) Kuwait, and
- 5) France.

The SWF activity of these nations is analyzed. The data also identifies that the following Australian industries have received foreign government investment:

- 1) The Australian energy sector and resources sector,
- 2) The Australian Finance Sector,
- 3) The Australian Infrastructure and Utilities Sector

The implication of foreign government ownership and influence in these Australian industries is investigated. Economic security theory provides a framework for analysis of the areas of the Australian economy that must be protected from SWF influence. Economic security is defined as, “safeguarding the structural integrity and prosperity-generating capabilities and interests of a political-economic entity in the context of various externalized risks and threats that confront it in the international

economic system”.¹ Economic security theory provided by Christopher Dent identifies eight components of economic security: supply security, market access security, finance-credit security, techno-industrial access security, socio-economic paradigm security, trans-border community security, systemic security, and alliance security, and in addition the economic security nexus. This categorization of the components of economic security is referred to within the study when analyzing the aspects of the Australian economy that must be safeguarded from SWF activity.

Historic cases and issues raised by other nations in the literature reviewed are used to outline the threats and concerns raised in regards to SWFs, by the United States, the European Union, New Zealand, and International Agencies the IMF, G7, and OECD, allowing the lessons learned to be applied to the protection of Australian industries. Australia’s existing foreign investment policy and industry specific policies are reviewed in order to identify the effectiveness of existing measures to mitigate the threats posed by SWFs. The possibility of closer international cooperation as a result of SWFs is also investigated. The method used to assess the potential for greater international cooperation is an analysis of international relations theories, including reference to realist and liberal theory, interdependence, and the theory of future trade expectation.

Indirect SWF Threats to Australia: Foreign Influence in the Asia Pacific region

After addressing the direct threats to Australia’s domestic economy, the study assesses if SWF activity in Australia’s immediate area of interest, the Asia Pacific region, indirectly affects Australia’s national security. This final area of research asks the question, what should Australia do to protect its national security interests in regards to SWF investment in developing nations within Australia’s immediate area of interest?

This part of the study identifies the investing governments and the countries receiving SWF investment, and investigates the compromise of Australia's national interests posed by this investment. The Government of the Peoples Republic of China and the Government of Taiwan are the major investors in the Asia Pacific region.

The Asia Pacific region, and in particular the Southwest Pacific region is selected for investigation, as the literature reviewed identifies that the developing nations of the Asia Pacific region are strategically important to Australia and several other nations.² The literature identifies that Australia, New Zealand and the United States share mutual strategic interests of promoting economic development, political stability and controlling civil unrest; in order to prevent corruption, transnational crime and the harboring of terrorist cells. The methodology used, for this part of the study, is a qualitative analytical comparison of Australia's national security interests in the Asia Pacific region against the national security interests of the nations investing in the Asia Pacific. The next chapter presents the analysis.

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CHAPTER 4

ANALYSIS

Background

The existing body of literature in relation to SWFs identifies that SWFs offer both threats and opportunities to global finance and geo-politics. As such, SWFs present a dilemma as nations want to attract the benefits of foreign investment, while also safeguarding against the threats of foreign government influence. The threats raised in relation to SWFs are investigated in this analysis along with the potential opportunities related to SWFs. The methodology used for analysis is as outlined in Chapter Three. The primary research question is: Are SWFs a threat to Australia's national security?

Benefits of SWFs

SWFs are investments of a nation's foreign exchange reserves. Large surplus foreign exchange reserves have been accumulated by nations that export significant quantities of oil and gas, or in the case of China, Singapore and the Republic of Korea, nations that export significant quantities of manufactured goods. Traditionally, these nations either held the foreign currency as cash or invested the currency in government issued bonds in the nation from which the currency originated. However, with the emergence of large surplus foreign exchange reserves certain nations have chosen to create SWF to obtain a higher rate of investment return. Other benefits to the investing nations include the opportunity to hold on to finances for future national projects, or for transfer to future generations.

SWFs also offer benefits to the nations receiving the investment. SWFs facilitate the allocation of revenues from trade surpluses across nations, providing investment capital for economic growth and development. Thus, there is a dilemma for nations receiving SWF investment, as a nation can benefit from SWF investment; however, nations also have an interest in controlling the level of foreign government ownership in domestic industries.

SWFs continue to grow for several reasons, including: the transfer of a larger proportion of existing foreign exchange reserves into SWFs, the investment of additional money incoming from continuing trade surpluses, and the reinvestment of capital gains and dividends from the SWF investments. Many commentators propose some SWFs are investing not only for profit, but for the purpose of gaining geo-political advantages. The application of the growing influence of SWFs to international theory and practice is analyzed below, specifically investigating if SWFs are a threat to Australia's national security.

SWF Direct Threats to Australia

The emergence of SWFs has produced many assertions about various threats in regards to foreign government influence in domestic industries. A literature review by the author groups the threats related to SWFs into the following four categories:

- 1) Influence of company and industry activity towards the strategic interests of the investing nations.
- 2) Access to sensitive technologies and threats to defense industry.
- 3) Geo-political influence and leverage over the country receiving investment.
- 4) Ideological concern, over the cross-boarder nationalization of industries in

capitalist nations by communist and authoritarian regimes.

An analysis of each of these threats follows, by way of a review of each category, discussing the views of commentators, reference to historic examples, and analysis by the author to assess SWF threats to Australia's national security. This analysis allows the identification of measures that may be used to mitigate each threat. Analysis then turns to an assessment of the appropriateness of Australia's policies and practices to mitigate the threats posed by SWFs.

Foreign Influence of Australian Company and Industry Activity

Australia has attracted sizable investments from some of the world's largest SWFs. The most active SWFs in Australia have been the Singapore twins, Temasek and the Singapore Government Investment Corporation (GIC). Neither Temasek or GIC publish the value of assets by location, but the tracking of individual purchases suggests that Australian purchases by the Singapore SWFs total more than \$20 billion.¹ Singapore SWF investment in Australia may soon be overtaken by Chinese SWFs, including the Chinese Investment Corporation (CIC) established in September 2007. The CIC has \$200 billion of assets, however, may soon be responsible for managing China's \$US1.4 trillion in foreign exchange reserves.² Since the late 1990s, Australia has been a key country selected by China for investment, in order to secure Chinese access to a supply of raw materials. The Chinese International Trust and Investment Corporation (CITIC) became the first Chinese SOE to invest in the Australian resource industry when it took a 10% stake in Portland Aluminum Smelter in Victoria in 1987.³ Since then, Chinese Government SWFs have continued to invest heavily in Australia's energy, resources, and

infrastructure sectors. Middle Eastern SWFs also own a portion of Australian companies; detail of SWF activity in Australia is displayed in Appendix B.

Existing literature in relation to SWFs identifies that most OECD countries have raised concern in regards to SWF investment in: defense industries, ports, infrastructure and utilities, media companies, shipbuilding, aviation, banks, energy and natural resources. SWFs make foreign governments the owners of domestic companies. The foreign governments gain voting rights in company shareholder meetings, and also the opportunity to elect preferred persons to the company's board of directors; in this way it may be possible for the foreign government to bias company plans towards the strategic interests of the investing nation.

Relating this threat to Australia, Appendix B shows the majority of SWF investment in Australia has come from China and Singapore, and been focused on Australia's energy, resource, and infrastructure sector. There has been significant coverage of SWF investment in the Australian media. The key question to be answered is, is SWF investment a threat to Australia's national security, or is the recent coverage simply a passing emotional sensitivity and a form of investment xenophobia? A review of each Australian industrial sector receiving SWF investment follows, assessing the strategic value of each sector receiving SWF investment, and the threats associated with foreign government influence in that sector. Discussion specific to one sector occurs under that topic heading, other discussion that is relevant to two or more sectors occurs in under subsequent topic headings.

The Australian Energy Sector and Resource Sector. The protection of a nation's energy reserves and energy industry has emerged as a top national security concern of

many nations including Australia. In light of the emergence of SWFs, Australian policy makers must also consider the impact of foreign government ownership of the Australian energy sector. Australia is a net energy exporter. Australia is the world's largest exporter of coal, has 40% of the world's low cost uranium reserves, and is the fifth largest exporter of liquefied natural gas, overall ranking Australia as the ninth largest energy producer in the world.⁴ Australia exports 56.4% of its oil and petroleum production and imports 75.8%, meaning that, Australia's oil production could supply over 80% of its oil needs.⁵ As recently as 2003, Australia enjoyed a trade surplus in oil and refined products.⁶ Geoscience Australia predicts that Australia's net oil self-sufficiency will decrease from the current 80% to 20% over the next twenty years. The Australian Bureau of Agriculture and Resource Economics is more optimistic, predicting a decline of 50% over the same period.⁷ Either way, oil is a non-renewable resource, giving too much control of Australia oil reserves to a foreign government may result in the depletion of Australian oil more quickly than Australian policy makers would otherwise choose, and before alternate energy supplies are readily available.

Australian reserves of Uranium and liquefied petroleum gas are more plentiful than oil, and global demand for them is increasing. Japan, India, China, Indonesia, the United States, and several European countries have each signaled their intention to build new nuclear power plants in the coming decade. The International Atomic Energy Agency estimates that nuclear power will rise from the current level of 16% of world electrical supply to 27% by 2030.⁸ The shift towards nuclear power and natural gas is likely to increase Australia's energy exports. At today's production rates Australia has 110 years worth of natural gas, and continues to find new gas fields. Australian energy

currently accounts for 20% of export revenue and is increasing.⁹ As Appendix B shows, SWFs have begun to invest in both Australian natural gas and uranium.

The politics of energy security are increasingly treated as part of the traditional security agenda. An assessment of Australia's position as a net energy exporter, in a time of increasing energy competition, must consider the impact of foreign government ownership of the Australian energy sector. A report by Energy Australia identifies that "The Australian government believes that a freely operating global energy market is the best guarantor of global energy security." This Energy Australia report states, "history shows that global energy markets can be distorted by distrust, rivalry and power maneuvering. A comprehensive international energy security policy requires strategies to ensure that such considerations do not imperil the operation of the energy market."¹⁰ SWFs have the potential to impact on the free operation of markets; the China Government has demonstrated a clear intention of owning a share of Australian energy companies, in order to ensure Chinese access to energy required to support its growing domestic energy needs. The intention of Chinese SWFs, in this regard, is clearly beyond investing only for profit.

In a speech made on 5 Jun 2008, the Australian Minister for Resources and Energy, the Honorable Martin Ferguson, stated:

Resources and energy are the engine room of the Australian economy today, driving global economic growth unprecedented in world history,... in that context, energy security is one of the big issues confronting Australia and the world, for whoever controls access to energy resources controls economic growth.

Amongst his list of threats to energy and resource security, the Minister mentioned: "resource nationalization, unprecedented global growth and a scramble for resources, and the fundamental desire for nations to protect their own economic future."

The minister stated, “the world is retreating from the open markets and free trade that we have worked so hard to achieve since World War II.” The minister also observed that “Australia does not have an energy security plan,...we need one.”

It is suggested that the energy and resource plan, that the minister identifies Australia requires, take into account SWF investment in this sector of Australian industry. In particular, Chinese interests in the Australian energy and resource sector must be assessed. The extent of Chinese investment in Australian energy and resources is listed at Appendix B, this level continues to rise. In an article titled “Global Maneuvers in the Mining Sector,” of 7 February 2008, George Freidman observed:

*Beijing has no qualms about throwing state funds into acquiring energy assets, even at a loss, because of the political rather than economic cost benefit analysis it uses, ... China wants control over what it considers strategic resources – energy reserves, minerals and metals that feeds its industrial growth.*¹¹

Freidman explains, China seeks minimal reliance on free market imports and pursues ownership of foreign companies, to ensure self-sufficiency as a matter of national security. He claims this is required due to PRC Government’s grip over China’s internal political and social stability depending on continued economic growth, for which stable energy and industrial supplies are essential. Buying up controlling ownership in resources assets in Australia and elsewhere reduces the risk of foreign companies or governments reneging on contracts and crimping parts of China’s supply chain.¹²

As owners of Australian companies via SWFs, foreign governments gain shareholder voting rights and the ability to appoint directors to company boards, in this way they can influence company activities towards the strategic interests of the Chinese Government. The interests of the foreign governments that are within the capacity of SWFs to influence include: setting the rates of production (production rates

that could be contrary to more sustainable development quotes envisioned by Australian policy makers); choosing the customer receiving Australian energy (ie. Chinese markets and not Australian markets or customers that a free market would decide); and the setting of prices (it is possible that a foreign government could subsidize the company, thereby selling at a financial loss, avoiding payment of otherwise higher company taxes to the Australia Government, but also lowering price of commodities for other Australian producers).

An example of the extent of Chinese influence in the Australian resource industry is the iron ore rich Mid-west region of Western Australia. A Chinese Government SWF consortium owns 100% of Midwest Iron (an iron ore company), has applied for 49% of Murchison Metals (also in the Midwest region), and is in the process of acquiring a 87.5% stake in Yilgarn Port and Rail project in the Mid-west region, this would provide the Chinese Government complete vertical ownership of iron ore production. That is ownership of the mine, rail and port operations of the Mid-west region, a region of Australia that is second only to the Pilbara region of Western Australia in iron ore reserves. This gives the Chinese owned operation immense flexibility to set prices, production and markets, and to conduct cost and price transfer along the vertically owned production process to avoid Australian taxation and to destabilize the price of Australian iron ore.¹³

Another, much publicized issue has been Chinese SOE Chinalco's investment in 9% of resource giant Rio Tinto for \$15 billion, with the apparent aim of blocking the takeover of Rio Tinto by BHP.¹⁴ The Chinese fear the takeover, as combined the companies would control around half of global metallic resources, this monopoly power

is likely to raise global prices for metals, and compete with Chinese aims of securing access to resources. Australian interests on the other hand, both government and private, are likely to be in favor of the takeover, as a large proportion of both companies operations are in Australia, or relate of shares listed on the Australian stock exchange (Both Rio and BHP, are multinational corporations, listed on three stock exchanges - Australia, London and New York, and maintain mining operations across the globe). The decision on the Rio-BHP takeover is still pending but with 9% control of Rio's voting shares the Chinese Government have a strong influence on the outcome.

In 2007 iron ore accounted for 7.5% of Australian exports, and is likely to increase due to infrastructure investment increasing the capacity of mining operations and the 85% increase in the contract price for iron ore that occurred in early 2008.¹⁵ Other mineral resources together account for 26.5% of exports, adding energy resources (coal, oil, natural gas and uranium) all resources account to 46.5% of Australian exports.¹⁶ Maintaining control of Australian exports and limiting any negative effects from foreign government ownership is a challenge facing the Australian Government.

Australian currently enjoys a positive trade and investment relationship with China. Chinese demand for Australian resources has been a significant driver of Australian growth and economic prosperity over the last decade. Chinese SWF investment has provided much of the capital needed to develop resource infrastructure, rail and ports. Australian policy makers must continue to monitor the level of SWF investment in the Australian energy and resource industry to ensure the potential threats do not eclipse the benefits of SWF investment. The existing Australian policy and industry regulations that are available to mitigate the negative effects of SWF ownership

of the Australian energy and resource sectors are discussed below, together with other Australian industrial sectors.

The Australian Financial Sector. To date the Australian financial sector has received some investment from China via the SWF State Administration of Foreign Exchange (SAFE) Investment Company; yet not nearly as much investment as the Australian energy and resource sector. Three of Australia's major banks (ANZ, Commonwealth Bank, and the National Australia Bank) each have less than 2% Chinese Government ownership.¹⁷ Currently, the level of SWF ownership of Australian banks does not raise concern. The measures available to mitigate investment in the Australian financial sector, if SWF investment does rise to a threatening level, are discussed below.

Access to Sensitive Technology and Protecting Defense Industry

Another threat in regards to SWFs, is that a foreign government may gain access to sensitive technology and rights to protected intellectual property and transfer that knowledge back to the investing nation, or an adversary, thus compromising a sensitive capability. This is of particular concern in respect to defense industry.

A review of historic cases identifies that European firms have expressed concern that the Russian Government has invested in European engineering, aviation, and defense companies for the purpose of accessing technological knowledge. An example is the Russian SOE Vneshtorgbank's purchase of a 5% stake of European Aeronautic Defense and Space Company (EADS) in 2006.¹⁸ Following the combining of the two companies, it has been claimed that technological transfer is possible, and that this was the intention of the Russian purchase. A U.S. Senate discussion in February 2008 voiced concerns that SWFs could gain access to sensitive technologies and classified information through

equity stakes in U.S. companies.¹⁹ A 2003 Pentagon report found that the 50 largest defense suppliers of 1980 have since combined to become five defense contractors dominating the global defense industry.²⁰ Terrence Guay's 2007 study, introduced in Chapter Two provides relevant assessment. Guay concludes that globalization has blurred the distinction between a domestic and foreign defense company. He finds that foreign ownership of the defense industry is a practical outcome of the globalization of capital, production, trade, technology and labor. Guay claims that policies that aim to keep the artificial distinction, of domestic and foreign defense companies, are not helping the defense industry obtain the best technology, national security or economic competitiveness.²¹

Turning to the Australian defense industry, investment from a publically listed company with 19% French government ownership is evident. Australian Defence Industries (ADI), Australia's key defense contractor, was purchased by a partnership between Transfield (an Australian publically listed company) and Thales (a French publically listed company) in October 2007, to become Thales Australia. Thales is a publically listed company on the Euornext stock exchange, the Thales website reveals however that the French public sector owns 38% of the voting stock of Thales International.²² As Thales international holds 50% of Thales Australia, this places approximately 19% of the voting stock of Thales Australia in the hands of the French public sector. The purchase of ADI by Thales was approved by the Australian Treasurer, following recommendation by the Australian Foreign Investment Review Board (FIRB) in October 2007.

Thales Australia (formerly ADI), is Australia's largest defense contractor, employing 3,700 personnel across 35 Australian sites. Equipment manufactured by Thales Australia includes: the vast majority of Australian ammunition and explosive ordnance, the Australian standard issue rifle the F88 Austeyr, the Bushmaster protected mobility vehicle, the ANZAC class Frigate, and several electronic warfare systems, to name a few.²³ ADI was a 100% Australian Government owned SOE until as recently as 1999, when it was initially privatized by sale to two Australian companies. The first foreign ownership of ADI was the sale to Thales in October 2007.²⁴ Obviously, the FIRB and the Treasurer were satisfied with the procedures in place to protect Australian defense industry, when approving the sale to the French company with 19% ownership by the French public sector. Furthermore, a Senate inquiry was held after the sale, one of the objectives of the Senate inquiry was to investigate the impact on Australia's national security and defense industry. The Senate inquiry was satisfied with the procedures to safeguard Australian national security as a result of the sale of ADI to Thales.²⁵

Australian Defense policy documents identify that Australia policy makers are well aware of requirements to protect Australian defense industry. Australia's *Department of Defence The White Paper 2000* recognizes that, "Australian industry is a vital component of Defense capability, both through its direct contribution to the development and acquisition of new capabilities and through its role in the national support base."²⁶ The importance of Australia's defense industrial base to national security appears again in *The Defence Capability Plan: Public Version 2006-2016*; *The Defence and Industry Policy Statement 2007* and *The Defence Procurement Review 2003*. These documents identify that Australian industry is of national strategic importance.

The detail behind these policy statements includes a series of practices and partnerships between the Australian Department of Defence and Australian industry and foreign private contractors attempting to ensure Australia's defense capability requirements are not compromised. The Australia Department of Defence's engagement with Australian industry maintains the ability to manufacture certain military items in Australia. Other items are sourced via foreign private contractors, including contractors in the United States, and Europe. Partnership includes: the Australian Industry and Defence Network (AIDN), the Australian Industry Group Defence Council (AIGDC), the Skilling Australia's Defence Industry (SADI) program, and the Australian Business Limited Defence Industry Unit (ABLDIU). Under these forums the Australian defense industry has been referred as the Australian Defence Force's (ADF) "fourth arm" and there is a dedicated division within the Defence Material Organisation (DMO) to manage the relationship with defense industry.²⁷

It is evident that Australian policy makers and practitioners maintain tight regulation over the Australian defense industry. However, to some the fast turn around of ADI from a 100% Australian SOE as recently as 1999, to 19% foreign government ownership in 2007, may sound like the small edge of the wedge. However, the conclusions from Terrence Guay's 2007 study, indicates that Australia must engage foreign capital and foreign expertise in order to obtain the best contractor support to its defense force. Guay's conclusion is sound and has direct application to Australia, Thales has enormous experience in developing technical systems for joint systems, and Australia has a lot to gain from engagement with Thales. Nevertheless, it is important that Australian policy makers continue to monitor developments in the defense industry.

Details of the FIRB and other Australian policy to mitigate foreign government ownership is described below.

Geo-Political Leverage

The literature reviewed, identified claims that a nation employing SWFs may gain increased geo-political influence and leverage over not just a company or an industry, but over the strategic decisions of a Government. At its extreme, in the event of hostilities, it is claimed that deliberate acts of economic sabotage may be used.

An investigation of Australia's utilities sector reveals considerable ownership by the Singapore government. The total of Singapore SWF investment in Australian utilities is approximately \$12.9 Billion, across four electricity and gas providers. This includes monopoly ownership of electricity utilities in the state of Victoria, a substantial share of natural gas utilities in South Australia and Victoria, and ownership of the Basslink electrical cable linking Tasmania to the Victorian electrical grid. Singapore is an ally of Australia under the Five Power Defence Arrangements (FPDA), and Australia and Singapore enjoy a close trading relationship. However, this level of foreign government ownership provides control of electrical utilities for approximately 25% of Australia's population and businesses. This situation will be analyzed to assess if Singapore has the potential for geo-political leverage over Australia. First, comparison is made to how the New Zealand and Japanese governments responded to similar situations in their countries; and foreign ownership of Australian ports is introduced.

Comparing a similar situation in New Zealand, in April 2008 the New Zealand government rejected a bid from the Canada Pension Plan Investment Board (CPPIB), to buy a 40% stake in Auckland airport,²⁸ as well as a separate bid from a Hong Kong

company to buy the main electrical utility supplier to the N.Z. capital city, Wellington.²⁹ New Zealand and Canada are close Allies cooperating under the Australia, Britain, Canada, Australia (ABCA) Program for defense cooperation, and as members of the Commonwealth of Nations they share Queen Elizabeth II as the Head of State. Despite this close relationship both bids were rejected by New Zealand on national security grounds.³⁰

In another example, Japan rejected, on national security grounds, a bid from the Children's Investment Fund (a U.K. private hedge fund with a charity arm) to raise its ownership of Japanese electricity company J-Power from 9.9% to 20%.³¹ These rejections by New Zealand and Japan, both in national security grounds, are an interesting contrast to Australia's acceptance of large investment in its utilities industry by Singapore SWFs.

The Dubai Government owns facilities and stevedoring services at half of all Australian ports. In March 2006, Dubai Ports World, which is wholly owned by the Dubai Government, purchased 100% of Peninsular and Oriental Steam Navigation Company (P&O) of the United Kingdom. This made Dubai Ports World the four largest global port operator. This includes Australia's five largest ports (Ports: Adelaide, Brisbane, Fremantle, Melbourne and Botany), and control of all sea-borne import and export to Australia's five largest population centers (approximately 80% of the Australian population and businesses). Initially the purchase included 22 ports in the United States, however, United States concerns in regards to border security and geo-political influence, led to a bill being passed in the U.S Senate to block the sale of U.S. ports. Dubai Ports

World was forced to sell the U.S. ports to American International Group, but maintained ownership of the ports of other nations including Australia.

The United State decided that the Dubai Government's ownership of its ports was a national security threat, related to the potential to disrupt port operations and to interfere with border security.³² Australia's five main ports, responsible for the export and import of goods to 80% of its population, remain owned by the Dubai government. It must be acknowledged that the timing of the U.S. Senate decision, in the wake of the 9/11 terrorist attacks, must have been influenced by a level of emotion, as well, as rational security concern. Nevertheless, the United State removed any potential threat from the Dubai Government, while that potential threat is still facing Australia.

Referring to Christopher Dent's components of economic security that a nation must protect. Control of electrical and gas utilities relates to "supply security," as in a modern economy electricity is an essential supply for private citizens and businesses. While, the monopoly ownership of ports, corresponds to Dents listing of both "supply security" and "market access security", as ports control the flow of both sea-borne imports and exports, to and from domestic and foreign markets. But can the governments of Singapore and Dubai use this ownership to influence the strategic decisions of the Australian Government?

Delving into how such geo-political influence may be exercised gets complicated and speculative. For a start there would have to be a disagreement between nations who, are allies in the case of Australia and Singapore, and who share friendly relations (including defense cooperation) in the case of Australia and Dubai. Second, the physical infrastructure (power supply, electricity grid, and ports) are in Australia, and the workers

and management are essentially Australian. If operations of these industries were deliberately disrupted to apply political pressure, it is possible for Australia to seize the facilities and recommence the distribution of electricity, or the operation of the ports, albeit after a period of disruption.

In regards to concerns about border security due to foreign ownership of ports, the workers and management at Australian ports remain essentially Australian. Furthermore, the laws and regulations in regards to port security are Australian laws, and inspections are carried out by Australian Customs and the Australian Quarantine and Inspection Service (AQIS). As such, it is assessed that the foreign ownership of Australian ports by Dubai Ports Worlds has negligible impact of Australian port security.

An example of a nation exercising political leverage via the ownership of utilities is the Russian Governments influence over its neighbors as a result of its control of natural gas supply. The Russian SOE Gazprom provides 98% to 100% of the natural gas used by Belarus, Bulgaria, Estonia, Finland, Georgia, Latvia, Lithuania, Moldova, Slovakia; Greece 82%, Turkey 65%, Germany 39%, and France 24%. A United States Report for Congress, in regards Russian control of natural gas supply to Europe, reported that “actual and threatened cut-offs have provoked criticism that Russia is using energy as a political tool.”³³ A recent report by Strategic Forecasting Incorporated explained that Russia holds geo-political influence over Germany due to Russia’s supply of more than one third of Germany’s natural gas requirements; it was reported that Germany’s diplomatic opposition to Russian actions, including the recent Russian invasion of Georgia, have been muted as a result of the geo-political leverage resulting from Russian gas supply.

In the case of Russian gas supply to Europe, the source of the gas is in Russia and pipelines out of Russia physically deliver the gas to Europe. Thus, it is possible for Russia to physically cut supply. This is somewhat different from the situation of Singapore and Dubai ownership of Australian electricity and ports; as in the Australian case all facilities are in Australia, making it more difficult to disrupt operations, and easier for Australia to restore operations. Nevertheless, the Singapore and Dubai governments gain potential for a small, speculative and unquantifiable level of leverage over Australian Government strategic decisions in the event of hostilities. However, due to the limited means to exercise influence and the current positive relations between nations it is assessed that this ownership does not pose a significant threat to Australia.

Consideration must also be given to the effect that a foreign government can have if it sold a significant portion of its investments on the Australian stock market over a short period of time. The effect would include a drop in the stock price of the companies concerned. The selling of a large amount of stock could result in the drop of that sector of the stock market, and this could be transferred to a drop in the overall Australian stock market. The selling of Australian currency to redeem the investment back into the currency of the investing nation could then lower the exchange rate of the Australian dollar. The literature review mentioned how the United States uses such a tactic to cause economic distress and pressure the governments in the United Kingdom, France and Israel during 1956 Suez Crisis, by aggressively selling each respective currency. Another notable incident is the action of George Soros on “Black Wednesday” 16 September 1992, to “break the Bank of England” by short selling the British pound.³⁴ Soros struck again during the 1997 Asian Financial Crisis, taking advantage of deteriorating economic

conditions to profit from exacerbating the Asian financial crisis. The Malaysian Prime Minister and officials in Thailand referred to Soros as an “economic war criminal”.³⁵

But have any of the nations investing SWFs in Australia expressed an intention to use SWFs as a tool of economic warfare? The literature review identified the book *Unrestricted Warfare* (1999), authored by two Chinese Army Colonels; this book provides evidence that China is well advanced in understanding the wide array of national tools available in the age of global finance. *Unrestricted Warfare* discusses:

*There is nothing in the world today that cannot become a weapon ... as we see it, a single man-made stock market crash, a single computer virus invasion, or a single rumor or scandal that results in the fluctuation in the enemy countries exchange rates or espouses the leaders of an enemy country on the internet, all can be included in the ranks of new-weapon concepts ... The new concept of weapons will cause ordinary people and military men alike to be greatly astonished at the fact that commonplace things that are close to them can also become weapons with which to engage in war.*³⁶

This book provides a clear warning of the potential for SWFs to be used to exert geo-political influence. The selling of a large quantity of investments over a short period of time could cause a financial crisis. Such action is likely to also cause some initial economic disadvantage to the investing nation, as any remaining investments would fall in value, or other interdependent linkages harm the investing nation. However, an authoritarian nation is not directly responsible to its citizens and may choose to absorb the financial loss as the cost of war. Strategic decision making may consider the cost, of economic damage to the investing nation, to be equal to or less than the losses expected during the waging of a conventional war.³⁷

The potential for Singapore, China, or Dubai to mount financial attack against Australia appears very remote considering that the nations currently enjoy a mutually beneficial trade and investment relationship. However, mutually beneficial trade and

friendly relations existed between the United States and the United Kingdom, France and Israel when financial coercion was used during the 1956 Suez Crisis. Thus, it must be acknowledged that SWFs do provide the investing nation with the potential to use financial coercion via the rapid selling of SWF assets.

To quickly address a few remote possibilities, the majority of the nations holding SWFs are authoritarian, what would happen to the investments if a revolt led to a change of government within a nation holding SWFs? Could a new rebel faction have a desire quickly cash-in an investment triggering economic pain for Australia? Or if one or more nations combined (think of possible Chinese/Taiwan reintegration) would the combined entity control an undesirably large amount of Australian industry? These possibilities are obviously speculative and will not be further investigated, however, it must be remembered that the international landscape of national borders is forever changing. Further, investigation of the potential for SWFs to influence the strategic decisions of the Australian government occurs below under discussion of interdependence theory.

Ideological Concern

SWFs have raised concern for ideological reasons, as SWF investment equates to the cross-boarder nationalization of industries in capitalist nations by communist and authoritarian regimes. Some SWFs may not help themselves in this regards by choosing some highly visible ‘trophy investments’ such as: the Chrysler Building of New York City (owned by the Abu Dhabi Investment Council), Melbourne’s Rialto Tower (Australia’s highest office building, 50% owned by the Kuwait Government), and Manchester City football team (owned by the Abu Dhabi Investment Council). These trophy investments may be an expression of nationalistic ego by the SWFs concerned,

and may in turn result in an emotional response from the nations having their national icons bought by a foreign government, but assessed to be of limited consequence to this study.

Beyond trophy investments, SWF investment is a change from the privatization of industries that has occurred in most of the western world throughout the 1970s and 1980s, back to nationalization of industries; however, under SWFs the nationalization is coming across national borders from a foreign government. This challenges the economic security components ‘socio-economic paradigm’ and ‘systemic security’ identified by Christopher Dent. Australia and other western nations have chosen a system of free markets, or at least mixed markets, and minimal government ownership (to varying degrees depending upon the country involved and the political party in the majority). Experience over the last 30 years has suggested that a system of majority privatized industry is efficient in allocating jobs, and delivering goods and services. The current Australian economic paradigm, of market liberal capitalism, is starting to be challenged by SWFs. Observers inclined to a preference for a political-economic system of increased government ownership would also be concerned for the shift in paradigm if the government exercising control was not its own.

The Singapore and Chinese Governments each control more business assets in Australia than the Australian Federal Government.³⁸ Many SWFs are aiming to participate in free markets solely in the pursuit of profit. However, there is potential for SWFs to affect the current economic paradigm of free markets. The concern of Chinese nationalization of the Australian resource and energy industries in order to control access to raw materials and energy has already been illustrated. SWFs have the potential to buy

up competitor companies and to obtain vertical ownership of the production process, they can influence the markets to which they sell, prices, and rates of production, and affect the principles of free market competition. Such actions are perfectly logical for the SWF concerned from a commercial perspective, however, could be problematic from the perspective of policy makers concerned about the scale of foreign government influence in the Australian economy. Australian policy makers should ensure that SWFs do not develop to a level that adversely effects the operation of free markets. The effectiveness of Australian foreign investment policies to mitigate the threats of SWFs are outlined below.

Mitigation

Australian Foreign Investment Policy

Given the threats discussed above, consideration must be given to existing Australian foreign investment policies, in order to assess if the threats associated with SWFs can be mitigated by existing measures or if additional regulations are required. Carl Ungerer provided the report *A New Agenda for National Security* through the Australian Strategic Policy Institute in April 2008. Ungerer investigated emerging international security issues such as organized crime, pandemic diseases and climate change. He asked what bureaucratic changes are necessary to deal with the contemporary security environment. He argued that “non-traditional security risks only become a national security risk when they meet the benchmarks of scale, proximity and urgency.” He notes that, “these criteria are not exclusive and can be limited by the range and availability of resources to respond.”³⁹ Using Ungerer’s evaluation SWFs would not be considered a security threat of national importance if existing policy instruments were

adequate. The existing Australian policy and regulations to mitigate SWFs are outlined below, including Australia's new six *Principles Guiding Consideration of Foreign Government Related Investment in Australia*.⁴⁰

The Australian government has demonstrated awareness of the emergence of SWFs. In a statement directed to the governments behind SWFs, on 9 April 2008 while attending a meeting in Beijing, Australian Prime Minister Kevin Rudd stated:

[As Prime Minister I will] defend the Australian national interest and the Australian national economic interest, and I make no apologies for that... Australia is an open market when it comes to foreign investment and we have a history of depending on foreign investment... We have always had proper regulations to examine and advise on projects of consequence.

On 17 February 2008, Australia became the first country to release a set of guidelines that apply to all investments by foreign governments. The *Principles Guiding Consideration of Foreign Government Related Investment in Australia*, released by the Australian Treasurer, outline six principles by which proposed investment by foreign government entities will be measured. The principles build on the existing framework of Australia foreign investment policy and the *Foreign Acquisitions and Takeovers Act 1975*, and the *Foreign Acquisition and Takeovers regulations 1989*. Under the policies certain investments must be notified to the Treasurer and the Treasurer may prohibit investments that are deemed to be contrary to Australia's "national interest." The term national interest is not defined in either the policy or the Act, meaning the Treasurer enjoys considerable discretion in exercising this power.

The policy distinguishes between investments by private entities and foreign governments. Foreign Direct Investments (FDI), defined as an investment of 10% or more, of an Australian company by a foreign government must be reported to and

approved by the Treasurer. This includes any entity with 15% or more foreign government ownership. Portfolio investment (less than 10% ownership of a company), is regarded as having the primary purpose of investing for profit rather than for gaining influence over company strategic direction; portfolio investment does not require approval by the Treasurer.⁴¹

The Australian Treasurer's six principles include:

- 1) An assessment of whether the investor's operations are independent from the relevant government.
- 2) Whether the investor is subject to or adheres to the law and observes common standards of business behavior.
- 3) Impact on competition.
- 4) Impact of government revenue.
- 5) Impact on national security.
- 6) Impact on the operations and directions of an Australian Business.

These new principles reflect the concern in recent research by the IMF about the transparency of SWFs. The treasurer has also sought to reassure investors that Australia remains welcoming of foreign investment. Arguably, this addresses the IMF's other concern that a reaction against SWFs may trigger protectionist actions that would be an obstacle to the maintenance of a free trade and free investment environment.⁴²

The Treasurer is assisted in making his determination by the Foreign Investment Review Board (FIRB). In addition to the Australian foreign investment policy and the Act, and the new principles there is existing legislation related to foreign investment in prescribes sensitive industries, including: Media; telecommunications; transport; training and human services; defense industry and defense technology; uranium, plutonium and nuclear. On the 24 June 2008, a background note was prepared for the Members and Senators of the Australian Parliament providing a summary of the responsibilities and powers of the FIRB regarding the takeovers of Australian companies by overseas companies. The note also covers the emerging issues associated with SWFs.⁴³

The Australian policy outlined above provides the Australian Treasurer with considerable discretion in determining what constitutes the national interest, following investigation and recommendation by the FIRB. The existing policy supplemented by the new principles provides strong mitigation against the threats associated with SWF. The release of the principles provides reassurance that Australian policy makers are aware of the threats and opportunities associated with SWF, and furthermore, that they are prepared to intervene when needed to protect the national interest. The intent of the new six principles is to highlight the need for transparency and regulation of SWF investment. While, conscious of the threats, the statements released by the Australian Government acknowledge that once regulated SWF investment offers significant benefits to the Australian economy.

There are threats associated with SWFs. SWFs also offer benefits to both the investing nation and the nation receiving the investment. Australian national policy and emerging international principles are progressing towards making SWF activities

transparent and regulated. The operation of transparent and regulated SWF would greatly reduce the suspicion surrounding SWFs, mitigate the potential for negative effects and allow both the investing and the invested nation to enjoy the benefits of SWFs.

This section has addressed Australian domestic regulations that can mitigate SWF threats. Action by international organizations to mitigate the threats of SWFs, including the newly formed “International Working Group of SWFs’ and its ‘Santiago Principles’ are outlined in a subsequent section following discussion of SWF activity in the Asia Pacific region. But first, analysis turns to the macroeconomic conditions underlying Australia’s need to accept foreign investment in order to finance its current account deficit; and, the United States foreign investment policy is investigated to allow a comparison to Australian policy.

Macroeconomics: Australia’s Current Account Deficit and the Need for Foreign Investment

The focus of this study is assessing potential threats to Australia’s national security and not issues of macroeconomics. However, to complete a thorough analysis of SWFs reference must be made to the underlying factors contributing to Australia’s requirement to attract foreign investment. As at the end of the June quarter 2008, Australia had a current account deficit of AU\$12.7 billion (after reaching a record high deficit of AU\$19.5 billion in March 2008).⁴⁴ This means that Australia spends more on imported goods than it earns on exports. This deficit must be financed. A current account deficit can be financed in two ways, by increased borrowing from overseas or by increased equity investments by foreigners into Australia. In theory, a current account deficit could be entirely financed by foreign equity investments in which case there

would be no need to borrow any overseas funds at all. In practice however, deficits are financed by a combination of foreign borrowing and foreign equity investments.⁴⁵

Thus, there is a requirement for Australia to receive foreign investment (or to borrow foreign money) to pay for the fact that it spends more on imported goods than it earns on exports. If it was deemed that foreign investment was too high, it follows that one solution for stopping the need for foreign investments would be for Australians to save money and invest in Australia or to spend their money in Australia, rather than spend money on imported goods. However, it is not this simple, as it is hard for a nation with Australia's small population to produce the diversity of goods available in the world. Furthermore, many imported goods are relatively cheap compared to goods made in Australia due to Australia's high standard of living and associated higher cost of labor. What Australia has a lot of, is good at producing and what the world currently needs is resources. Specifically, iron ore, other metals and coal needed by China to support its rapid development. To get the greatest benefit out of this situation, Australia must increase the capacity of its resource industry (including, the capacity of mining operations, railways and ports). This increase in resource industry capacity needs investment capital. Foreign investment can therefore assist to finance the expansion of the Australian resource industry, increasing the quantity of Australian resources available for export and assist in reducing the current account deficit.

Australia's current account deficit (combined with that of other nations) is the underlying reason for the build up of trade surpluses in the nations holding SWFs. These nations holding SWFs have the requirement to invest this money somewhere, and Australia has the need to receive foreign investment to finance its current account deficit.

SWF investment in the Australian resource industry can recycle this surplus, assisting in financing Australia's current account deficit; but it can also, assist in expanding the amount of Australian exports reducing the underlying cause of both Australia's current account deficit and reducing the build up of SWFs (ie. surplus foreign exchange in other nations, accumulated via a trade imbalance). Increasing the export of Australian resources also provides profits and wages to Australian companies and workers, and royalties and taxes to the Australian government.

Following this line of thought and the apparent benefits to Australia, it would appear foolish for the Australian Government to refuse foreign government investment in its resource industry. However, it appears that it is precisely the desire to maintain these benefits that has prompted the Australian Treasurer to carefully consider SWF investment in the resource industry. The Australian resource industry accounts for approximately 46.5% of Australian export earnings (and is growing), it employs eight percent of the Australian workforce.⁴⁶ Yet, only 20% of the Australian resource industry is owned by Australian investors.⁴⁷ The majority is owned to foreign private investors via multinational companies; but the level of Chinese Government ownership is growing and targeting specific sectors, giving China the ability to influence prices, production and markets within certain sectors. The *National Strategic Plan for the Geosciences*, states that "the Australian Government has recognized the need for sustainable management of the nation's natural environment and resources in order to continue to build wealth."⁴⁸ Consideration includes that "over the next fifty years, it is estimated that the world will use five times the resources that it has mined to date."⁴⁹

The Australian Government must carefully consider how to best manage the Australian resource industry over the long term. It must balance the requirement to maximize the benefits of foreign investment, to safeguard against the threats, and must include maintaining favorable macroeconomic conditions to manage Australia's current account deficit.

United States Comparison

Paul Rose provides an analysis of SWF investment in the United States, in his article "Sovereigns as Shareholders" in the *Carolina Law Review* (Fall 2008). A review of Rose's findings is useful in drawing lessons relevant to Australia. Rose finds that, while "SWFs provide a tool that foreign governments could use to act in their own self interest, existing regulatory, economic and political factors protect the United States against most of the potential threats posed by SWF activities." Protections include the [U.S.] Foreign Investment and National Security Act of 2007 (FISIA), and the [U.S.] Exon-Florio provision under the Defense Production Act of 1950, implemented by the Committee on Foreign Investment in the United States (CFIUS), an interagency committee chaired by the Secretary of Treasury. The CFIUS aims:

To balance commercial and security concerns "through thorough reviews that protect national security while maintaining the credibility of our open investment policy and preserving the confidence of foreign investors here and of U.S. investors abroad that they will not be subject to retaliatory discrimination."⁵⁰

However, Rose notes that the risk of politicization of the CFIUS process is a subject of concern. This includes both, harmful political activities by SWFs, but more likely the risk of protectionist application of the CFIUS process. Rose notes that the greater risk is that protectionist regulations will dissuade SWF investment in the United

States, and likely result in investment in competitor, and less regulated markets. Rose proposes that “SWF investment in other markets may yet pose a danger to U.S. interests.” For this reason, he supports a “voluntary code of best practices that would serve to provide assurances that SWFs will invest apolitically in any market.”⁵¹

Australia must assess its interests and processes to mitigate the threats of SWFs independently; however, Rose’s assessment of the United States policy to manage SWFs provides Australian policy makers with a relevant case study. The United States experience supports the appropriateness of Australian policies to protect against direct SWF threats to Australia. However, Rose’s study also supports the thesis that while Australian policy provides protection against direct threats to Australian companies and Australian industries, developing nations within Australia’s area of interest are likely to remain vulnerable to SWF investment and geo-political influence. The indirect threat to Australia is investigated below.

SWF Indirect Threats to Australia: Influence in the Asia Pacific Region

SWF investment in developing nations in Australia’s immediate region may continue to indirectly affect Australia’s national interests. Developing nations are less likely to control foreign investment, as the legislative mechanisms of these nations are not sophisticated, and these nations are desperate to receive foreign investment funding to assist in overcoming endemic economic problems. The developing nations of the Asia Pacific have begun to receive significant foreign government investment from China and Taiwan. This investment is often unregulated and unconditional and provided without goals related to democracy, sustainable development, fair working conditions, and the environment, this may exacerbate underlying political, economic, and social problems in

the region.⁵² Thus, SWF investment in developing nations in Australia's area of interest is likely to continue to indirectly affect Australia's national interests. The indirect threat to Australia via SWF influence in developing nations is also the hardest for Australia to control, as Australian domestic policy does not cover SWF activity outside of Australia.

Thomas Freidman, two times Pulitzer Prize winner and regular contributor to the New York Times international relations column, provided a metaphor of an economic "golden straight jacket," first introduced in his work *The Lexus and the Olive Tree* (1999), which has an interesting application to the rise of SWFs investment in developing nations. Freidman used the metaphor of a golden straightjacket to describe the economic rules that the western world places on other nations via institutions such as the IMF, and the World Bank. Freidman's suggestion is that this economic golden straightjacket requires other nations to conform to market economic principles, reduce corruption, to promote human rights, democracy and other western ideals as a requirement to participate in the global economic system; to date this has supported western interests of spreading democracy and market principles.⁵³ The emergence of SWFs may offer an alternative to the western golden straightjacket. This is already evident in Africa, South America, and the Asia Pacific where China is offering SWF investment (and foreign aid), without asking for the same social compliance that western nations request. Unconditional SWF investment by nations such as China competes with western interests as the developing nations are not encouraged to adopt western principles.

Australia, New Zealand and the United States share mutual strategic interests of promoting economic development, political stability and controlling civil unrest in the Pacific region.⁵⁴ There is concern that Pacific Islands have weak political and legal

institutions, and that corruption and conflict related to economic scarcity could lead to failed states, attracting transnational crime and the possible harboring of terrorist cells.⁵⁵

Ungerer explains: “As a continental power facing three oceans, Australia’s economic and security interests are broad. [Australia’s] interests are directly tied to economic and political developments in the Asia Pacific region. We have global interests in a rules based economic order.”⁵⁶ Australia continues to provide the highest level of financial aid to the Pacific region.⁵⁷ In addition to financial aid, Australian assistance includes law and order and governance support via the deployment of Australian Federal Police and government advisor teams. Australia provides 22 naval patrol boats to 12 Pacific Island nations to assist them in monitoring their maritime areas (a program that has been running since 1987, but recent government discussion suggests is in peril due to funding constraints.)⁵⁸

The Asia Pacific region has been referred to as Australia’s “arc of instability.” Many nations of the Asia Pacific have suffered from conflict in recent years and in several instances Australian military intervention has been required to restore order. In the last ten years alone Australian military intervention has occurred in: Timor Leste (1999-2006, and 2006 to present), the Solomon Islands (2003- present), Fiji (2000, and 2006), Tonga (2006), and Papua New Guinea/Bougainville (1997-2003, and 2004). This regional instability threatens Australia due the associated attraction of transnational crime, people smuggling, drugs, refugees, and the possible harboring of terrorist cells by failed states. Efforts to prevent instability in the region expand Australian financial resources and use the time and energy of many Australian Government departments. In addition, the consistent deployment of Australian troops to this region has an opportunity

cost, as the troops deployed are not available for other tasks including commitment to Australia's wider bilateral and multilateral strategic alliances.

The People's Republic of China (PRC) and Taiwan have both become a growing force in the Southwest Pacific. They have both extended their diplomatic and commercial presence, including via the use of SWF investment, principally in order to garner political support in relation to the recognition of Taiwan. China is also pursuing access to fish stocks, and minerals; and possibly pursuing wider strategic influence in the region. Several analysts argue that this unconditional aid in exchange for support on diplomatic issues is unregulated and poorly managed, and may exacerbate corruption and political instability in the recipient countries, while not leading to broader economic development.⁵⁹

The report by the Lowy Institute's Fergus Hanson, *The Dragon Looks South*, of 10 June 2008, observes that China is now the third largest aid donor to the South Pacific after Australia and the United States. The report also notes that Beijing is just as ready to slash aid to nations that switch allegiance on the issue of recognition of the PRC over Taiwan. The nations of the Pacific offer 14 votes in the United Nations General Assembly and other international forums.⁶⁰ This is a large number of votes that can be bought relatively cheaply. Only 23 nations recognize Taiwan as a sovereign nation, six of them are in the South Pacific (the Solomon Islands, Kiribati, Marshall Islands, Nauru, Palau, and Tuvalu).⁶¹ The votes of the 12 other Pacific Islands have been bought by the Chinese Government (including: the Cook Islands, Fiji, Micronesia, Niue, Papua New Guinea, Samoa, Tonga, Vanuatu). Hanson's research finds that China does not release the value of its aid, but his research estimates that Chinese aid in the South Pacific grew from

\$33 million in 2005 to \$293 million in 2007. While these figures represent foreign aid, Chinese Government SWFs are amongst the mix of funds.

Hanson warns that China's investments are undermining Australian and other Western donor's in the region. His report states that the opaque nature of China's aid and investment undermines other nations' efforts to improve transparency, accountability, corruption, governance and stability. He finds that opaqueness also raises suspicion of China's motives. Following the latest military coup in Fiji in 2006, Australia and other western donors were exerting pressure on the Fijian coup leaders to restore democracy, on the other hand the Chinese Government provided investment totaling \$150 million, the largest Chinese aid package in Fiji so far.

In 2006 a Taiwanese delegation is alleged to have offered a payment of US\$30 million to Papua New Guinea (PNG) Government officials; the aim of the bribe was apparently PNG recognition of Taiwan. The \$30 million dollars is missing, and the PNG Government claim to have no knowledge of the deal. The resulting scandal has seen the resignation of the Taiwanese Vice Premier and Foreign Minister, and the credibility of the PNG Government has been undermined.⁶²

Chinese and Taiwanese vote buying has also occurred Timor Leste.⁶³ However, more alarming to Australia was the Chinese move to provide Timor Leste with two Chinese made patrol boat and training, announced in April 2008. The Australian Minister for Defence played down the Chinese move stating, "a significant proportion of East Timor's natural resources are based offshore, it is encouraging that East Timor takes its maritime security seriously and [Australia] will continue to develop links with their maritime element." Australian National University defense expert Paul Dibb stated that

the Chinese patrol boat offer highlighted Beijing's increasing influence in the region. In assessing the impact of the move Dibb suggested, "it is a matter of how much further it goes and what sort of footprint China sees it has the right to have in our immediate neighborhood, where clearly we see ourselves as the leading power with the most influence."⁶⁴ China's interests in Timor Leste include Chinese Government investment in Timor Sea energy projects.

Within the region Chinese investment is also found in mineral resources and timber principally in PNG, Fiji, and the Solomon Islands.⁶⁵ Other investments from China and Taiwan consist of construction projects such as government buildings and sports stadiums in capital cities that directly benefit the government in power rather than addressing underlying social and economic problems.⁶⁶

Responsible and well managed foreign investment can assist in the development of the Pacific; however, Hanson's study warns that Chinese and Taiwanese investment is not well managed. Hanson concludes the lack of regulation of foreign investment is likely to lead to corruption, and instability. He outlines that the intentions of Chinese and Taiwanese government investment is largely benign, he concludes that China's security ambitions in the region are modest and that most discourse regarding the strategic interests of China in the region are exaggerated. However, he remains concerned that the lack of accountability for the investment and the lack of oversight, may exacerbate underlying problems of corruption and political, economic and social instability.

Several studies have expressed concerns of the level of investment and the intentions of the Chinese and Taiwanese in the region, some expressing a greater level of concern than that raised by Hanson. Commentators writing for Strategic Forecasting have

provided a regular commentary of Chinese investment in the Asia Pacific and make a similar assessment as Hanson.⁶⁷ Other, studies have identified a resentment of the Chinese presence in the region, pointing to indigenous demonstrations in the Solomon Islands in April 2006, when looters and rioters accused the government of corruption and being unduly influenced by Chinese business interests and Taiwanese Government money. Similarly, indigenous rioters in Tonga, in November 2006 destroyed businesses owned by ethnic Chinese.⁶⁸ Ron Crocombe, Professor of Pacific Studies, University of the South Pacific, is more concerned about Chinese intentions and offers this candid assessment:

[China] wants to be the major influence in the Pacific, there is no doubt about that; it is aiming to be that in a fairly short time. It has been carefully planned, [there has been] very strategically placed aid. You'll notice Chinese aid is quite different... China is heading straight for the Jugular. 69

Concern for instability in the Pacific region is not new, nor is concern for Chinese influence in the region. What is new is the rise of SWFs. SWFs provide a new tool for nations, with large trade surpluses, to express their economic power, this tool is at play in Australia's close neighborhood of the Asia Pacific region. Chinese and Taiwanese SWF activity in the Asia Pacific region has the potential to indirectly affect Australia's national security. As discuss, this regional instability threatens Australia due the effects of transnational crime and the possible harboring of terrorist cells by failed states. In addition, the consistent deployment of Australian troops to this region has an opportunity cost, as the troops deployed are not available for other tasks including commitments to wider strategic alliances.

If delivered responsibly aid and investment from other nations has the potential to support Australian interests in the region. Australia should continue to engaged China

and Taiwan via diplomatic forums to discuss the management of aid and investment. Australia is in a strong position to discuss its concern with China and Taiwan. Australia and China, and Australia and Taiwan enjoy a strong trading relationship. China is Australia's largest trading partner, Australia exports to China grew by 39% in 2005-2006. In September 2008, Australia and China completed the twelfth round of negotiation towards establishing a Free Trade Agreement. China remains dependent upon global export markets to support its growth, and it also relies on Australian supplies of raw materials. Relations are currently at a high point between the two nations; in part due to Australian Prime Minister Kevin Rudd's prior association and strong rapport with China. Prime Minister Rudd, studied Asia Studies majoring in Chinese languages and Chinese history, he is a fluent Mandarin speaker and served as a diplomat to China with the Australian Department of Foreign Affairs and Trade, also spending time working as the Senior China Consultant with accounting firm KPMG Australia prior to his career in politics. Australia should use its strong relationship with China to appeal for transparency and regulation of SWFs, and adherence to the new 'Santiago Principles', as well as adherence to the OECD's Development Assistance Committee (DAC) principles for foreign aid. Australia should address its concerns via bilateral discussion with China and Taiwan and also via multinational forums, those available include: the Asia Pacific Economic Committee (APEC), the United Nations General Assembly, the G20, the South Pacific Islands Forum, and the new International Working Group of SWFs.

International Steps to Mitigate Concern

Over the course of 2008 there has been rapid international progress to mitigate concerns in respect to SWFs. The international community with leadership by the G7,

OECD and the IMF is pushing for transparency and regulation of SWFs. The OECD and IMF joint conference, “Sovereign Wealth Funds in the Global Investment Landscape: Building Trust,” of 31 March 2008, provided an opportunity for representatives of sovereign wealth funds (SWFs), private financial institutions and recipient governments to share views on what steps SWFs and recipient governments can take to build mutual confidence and trust. This meeting led to further discussion by the G7 during the first week of April 2008. The OECD, IMF and G7 are principally concerned with maintaining free markets and avoiding protectionism.⁷⁰

The concerns raised by the international community led to the rapid establishment of the “International Working Group of Sovereign Wealth Funds” which held its first meeting 30 April – 1 May 08, at the IMF Headquarters in Washington, DC. The International Working Group (IWG) is co-chaired by a senior representative of the Abu Dhabi Investment Authority (ADIA) and the Director of the IMF’s Monetary and Capital Markets Department who were selected by the participating SWFs. The IWG member countries are: Australia, Azerbaijan, Bahrain, Botswana, Canada, Chile, China, Equatorial Guinea, Iran, Ireland, South Korea, Kuwait, Libya, Mexico, New Zealand, Norway, Qatar, Russia, Singapore, Timor-Leste, Trinidad and Tobago, the United Arab Emirates, and the United States. Saudi Arabia, Oman, Vietnam, the OECD, and the World Bank participate as observers. The aim of the IWG is to help maintain a stable global financial system, the free flow of capital and investment, and manage concerns of SWFs and the international community.⁷¹

A significant milestone was reached by the IWG during second meeting held in Santiago, Chile on 20 September 2008. The working group drafted a set of voluntary

“Generally Accepted Principles and Practices for the conduct for Sovereign Wealth Funds.” These have become known as the ‘Santiago Principles’ and were subsequently presented to the 11 October 2008 meeting of the IMF. Twenty four principles were identified to for which there are four guiding objectives: 1) To help maintain a stable global financial system and free flow of capital and investment. 2) To comply with all applicable regulatory and disclosure requirements in countries in which SWFs invest. 3) To invest on the basis of economic and financial risk and return-based considerations. 4) To have in place a transparent and sound governance structure that provides for adequate operational controls, risk management, and accountability. The Working Group also proposed to establish a standing group of SWFs that would keep the principles under review, monitor implementation, and continue dialogue with recipient countries.⁷² The rapid creation of the IWG, its quick action to develop the Santiago Principles, and the membership of Australia, China, Singapore, and the UAE provides a solid sign of progress in regards to the management of the Australian and international concerns in regards to SWFs. While, the ‘Santiago Principles’ are voluntary this is a positive step toward responsible, transparent and regulated SWF activity, and reducing the threats while enjoying the benefits of SWFs. Time will tell of the effectiveness and the level to adherence to the principles. In the interim Australia should continue to raise its concerns to the IWG and other international organizations, and continue to rely on its own domestic policies for the management of foreign government investment.

Interdependence and Cooperation Between Nations

Analysis turns to the potential opportunities for increased cooperation between nations as a result of interdependence, then switching to assessing if interdependence can

limit the strategic choices of a nation. Increased economic interdependence of nations as a result of SWFs may result in closer political cooperation between nations. For instance, if China, Russia and the nations of the Middle East have large investments in western nations, it follows that they also have a direct interest in the continuing prosperity of western nations. Similarly, if western nations have an interest in continued access to 'transparent and regulated' foreign investment via SWFs, in order to obtain capital for continued economic growth, they therefore have a reason to cooperate with the holders of SWFs.

The reader should not be surprised to hear that not all international relations theorists would agree on the proposal the SWF may promote increased cooperation between nations; realist and liberal theorists are likely to differ in their interpretations. However, the 'trade expectations theory' developed by Dale Copeland, introduced in Chapter Two, provides a valuable framework for analysis. Trade expectations theory suggests that realist and liberal theory is insufficient as it ignores the additional variable of "future trade expectation."⁷³ When considering the additional variable of expectation of future trade, Copeland's theoretical model suggests that if the investing and invested nation both believe that the activities of SWFs provide future benefits, then cooperation between the nations is likely. If the nations think that the benefits to be gained in the future are poor then conflict is more likely. Thus, it would appear that both the investing nation and the receiving nation can benefit from SWF investment that does not compromise specific industries. As such, nations would benefit from allowing SWF investment.

Furthermore, applying Copeland's theory to an analysis of SWFs, the theory suggests that overly protectionist restrictions on SWF investment may in fact lead to conflict. As in the absence of the opportunity to gain benefits via SWF investment and trade, which may include access of essential resources, the investing nation may turn to military means in order to obtain the required resources. This idea parallels the line of argument, proposed by Richard Rosecrance, in *Rise of the Trading State* (1986), in describing how the actions of Germany and Japan resulted in the Second World War. Copeland discusses Rosecrance's analysis of the decisions of Germany and Japan to use military force to obtain critical raw materials in the context of low levels of international trade during the 1930s that did not provide Germany or Japan with an expectation of future access to essential raw materials unless they resorted to military action.⁷⁴

SWFs are a new factor in an increasingly interdependent world; however, the world has been interdependent in varying degrees for the last century and has not been able to avoid major conflict. In 1910, the then President of Stanford University is reported to have said that future war was impossible due to: economic interdependence, ties between labor unions and intellectuals, the international flow of capital, and the enormous cost of war. Of course this prediction failed in 1914.⁷⁵ In the 1940s, the ideas of 'functionalism' became popular, suggesting that economic and social cooperation could create communities that cut across national boundaries and thus eliminate conflict. Functionalist thinking gave rise to international agencies such as the IMF, the World Bank, the World Health Organization, and agencies of the United Nations such as the Food and Agriculture Organization.⁷⁶ The idea that the emergence of SWFs promotes closer cooperation between nations is in the tradition of functionalist thinking. However,

the concept of state sovereignty remains strong and most states are reluctant to allow themselves to be interdependent to the extent that they become vulnerable to others.

Opportunity: Opening of Authoritarian Regimes.

Another potential benefit of SWF investment is that it may lead to more open and market orientated behavior within the investing nation. For example, engagement with China (and other authoritarian and communist nations) via SWFs, could be an additional step towards increased openness to western principles including: free markets, democracy, freedom of speech, and increased human rights. China's recent investments in western nations may also encourage Chinese reciprocity and provide western firms increased access to Chinese markets. Thus, SWFs could be a vehicle to support the national strategic interests of western nations in regards to opening authoritarian nations to western principles.

An analysis of the *National Security Strategy of the United States* (NSS) March 2006, reveals that:

The United States encourages China to continue down the road of reform and openness, because in this way China's leaders can meet the legitimate needs and aspirations of the Chinese people for liberty, stability, and prosperity...continuing along this path will lead to regional and international stability.

The U.S. NSS goes on to warn of some of the challenges in regards to China, stating:

However, [China's Leaders] cannot stay on this peaceful path while holding on to old ways of thinking and acting that exacerbate concerns throughout the region and the world. These old ways include: ... expanding trade, but acting as if they can somehow "lock up" energy supplies around the world or seek to direct markets rather than opening them up –as if they can follow a mercantilism from a discredited era; and supporting resource-rich countries without regard to the misrule at home or misbehavior abroad of those regimes."

SWFs are not mentioned in the U.S. NSS; however, considering the policy aims of the United States towards China, SWFs do appear to offer an opportunity to peacefully engage with authoritarian and communist nations, allowing a step towards opening these regimes to western principles. While there is an opportunity for increased cooperation between nations, there is also a risk that interdependence can limit the strategic freedom of action of a nation receiving SWF investment.

Limiting Freedom of Action

To investigate the idea that interdependence can limit freedom of action analysis will turn to a study of the economic relationship between the United States and Saudi Arabia, and the United States and China. The Kingdom of Saudi Arabia has allocated an estimated 60% of their global investments to the United States. Saudi Arabian investments in the United States have traditionally been a welcome counterweight to the systemic U.S. trade deficit with the Kingdom. This investment has contributed to enabling the United States to finance an ongoing trade deficit and has produced new economic growth opportunities.⁷⁷ Evidence suggests that the Saudi's invest such a high proportion of their wealth in the United States, in order to foster a close and interdependent relationship that counters other differences in strategic interests.

Saudi Arabia is one of the leading sources of imported oil for the United States, providing the United States with more than one million barrels/day of oil. The United States is Saudi Arabia's largest trading partner, and Saudi Arabia is the largest U.S. export market in the Middle East. 95% of Saudi oil is state owned and 60% of Saudi foreign investment is in United.⁷⁸ Saudi Arabia's investment in the United States, its possession of the world's largest reserves of oil, and its position as an authoritarian

Islamic regime make its relationship to the United States very important and very complex.

George Freidman, author and founder of Strategic Forecasting Incorporated, has pointed out that in the midst of the global war on terror, “one of the key goals of the U.S. war in Iraq was to put increased pressure on - and effect change in - Saudi Arabia.”⁷⁹ He claims action to pressure the Saudi’s had to occur subtly and indirectly as the complex interdependent relationship limited the ability for the United States to take direct action against the Saudi’s. In his book *America’s Secret War*, Freidman suggests that the United States conducted the war in Iraq with the expectation of a swift victory that would be a demonstration of United States strength and resolve to Islamic and rogue nations, including Saudi Arabia.⁸⁰ There is speculation that other desired outcomes of the war may have included the distancing of the United States from Saudi Arabia by the movement of U.S. regional military bases out of the Kingdom and into Iraq, and the potential to dilute the strategic power of OPEC, and reliance on Saudi oil by the establishment of a pro-western regime in Iraq. Arguably, Saudi Arabia has been able to escape greater United States pressure over its alleged links to Wahabi charities and jihadist terrorism, its poor human rights record because of its crucial role in United States energy and investment markets. While the U.S.-Saudi interdependent relationship offers some mutual benefits to both nations, it must be concluded that the complex relationship also limits the freedom of action of the United States. The United States has recently reinvigorated a campaign of “energy independence” aiming to “rid itself of foreign oil” and the associated complex relationship with the Middle East.⁸¹ The reason for studying this relationship as part of this analysis of SWFs is to identify that interdependence can

lead to a complex relationship that limits the freedom of action of the nation receiving investment.

Similarly Chinese investment in the United States may limit United States freedom of action in relation to issues in which it holds a different view than Beijing, including the independence of Taiwan. China holds \$388 billion in U.S. treasury bills.⁸² The Chinese trade surplus with the United States is US\$1.4 trillion and increases by approximately \$1 billion per day.⁸³ Beijing and Washington must both be well aware of the strategic leverage that Beijing holds as a result of this economic relationship; it is very difficult for a nation to argue with its banker. The U.S.- China relationship provides a further example of how interdependence may limit the freedom of action of a nation. Interdependence can create complex relationships between nations. While, an extrapolation of Copeland's theory suggests that SWFs may promote increased cooperation between nations and a reduction in conflict. This interdependence can also be an obstacle that reduces a nation's freedom of action, in dealing with the investing nation.

The engagement between nations as a result of SWFs offers benefits to both the investing and the invested nations. This may include recycling of trade surpluses across the globe, providing access to investment capital and producing economic growth, the distribution of resources via trade. Opportunities, of increased trade and investment include reducing the chances of a nation resorting to military action to obtain resource needs; and the opening of authoritarian and communist nations to the principles of free markets, democracy, freedom of speech and increased human rights. This is a long list of rose colored ideals; SWFs are not going to solve the world's problems overnight. Consideration of the potential opportunities must be conducted with appreciation of the

concurrent threats and challenges, competing national interests, and the limitations of the available mitigating measures necessary to ensure transparent and regulated practices by SWFs. While, there is an opportunity for increased cooperation between nations there is also a risk that interdependence can limit the strategic freedom of action of a nation receiving SWF investment.

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CHAPTER 5

CONCLUSIONS AND RECOMMENDATIONS

Globalization continues to evolve. SWFs are a result of the changing balance of power as certain nations grow significant financial wealth as a result of large trade surpluses from oil and gas revenue, and from the export of manufactured goods. SWFs have grown rapidly in the last ten years, and are already a significant force in global capital markets. There are approximately 40 SWFs in operation today. SWFs continue to grow in size and reach, and the exponential increase since 2000 shows sign of continuing.¹ The new era of presents increasingly complex challenges to Australia's national interests.

An investigation of SWFs reveals that it is a topic that crosses over many disciplines, including: global finance, trade and economics, national security, international relations, international and domestic law, and domestic industrial policy. Any study of the topic must make a choice in the trade-off between breadth and depth. Furthermore, as policy in relation to SWFs is rapidly developing any study risks being overtaken by events and becoming quickly outdated.

To illustrate the rapidly evolving policy in regards to SWFs, on 17 February 2008, the Australian Treasurer released a set of principles in regards to SWF investment in Australia, coinciding with the beginning of this study, during the nine months of this study several key developments have occurred. The G7 included SWFs as an agenda item at there 5 April 2008 meeting. The IMF and OECD held a joint meeting in London, on 31 March, to discuss SWFs; leading to the OECD release of a set of SWF guidelines on 9 April 2008. On 24 June 2008, a paper was prepared for Members and Senators in the

Australian parliament to describe the responsibilities and powers of the Australian FIRB and the emerging issues associated with SWFs. On 25 June 2008, a Sovereign Wealth Funds Summit was held in Sydney, Australia. The International Working Group of SWFs met in Santiago, Chile on 20 September 2008, developing the Santiago Principles that were subsequently presented to the IMF on 10 October 2008. The 2008 global financial crisis has developed, during which in many cases SWFs entered as welcomed rescuers of troubled companies providing much needed financial capital. In consideration of the rapidly changing nature of SWFs, this study provides an assessment of the benefits, threats and opportunities related to SWFs, increasing awareness of SWFs, and assessing if SWF pose a threats to Australia's national security.

Conclusions

SWFs offer both threats and opportunities to global finance and geo-politics. As such, SWFs present a dilemma as nations want to attract the benefits of foreign investment, while also safeguarding against the threats of foreign government influence. SWF investment in Australia has offered many benefits to Australia by recycling trade imbalances and providing investment capital for development of infrastructure in the energy and resource sectors. This development has resulted in increased trade, increased wages, profits and taxes increasing economic prosperity in Australia.

Many SWFs are aiming to participate in free markets solely in the pursuit of profit. It appears that in the case of certain Chinese Government investments in the Australia resource industry that the intention of the Chinese Government is access to and control of resources, rather than investing only for profit. In situations where the Chinese Government holds controlling stakes of companies, and/or vertical ownership of

production, it is possible for influence over production, markets, and prices. Such actions are perfectly logical for the SWF concerned from a commercial perspective, however, could be problematic from the perspective of Australian policy makers.

Much of this study has focused on the Peoples Republic of China this is a logical result of it recently receiving significant media coverage in regards to its investment in the Australian resource industry. Nothing found in this research suggests that China is interested in anything other than a 'peaceful rise.' Furthermore, China's peaceful rise has offered significant benefits to Australian economic prosperity by the purchasing of Australian resources and by providing capital investment for Australian infrastructure development. This has led to increased mining, rail and port capacity, which has brought higher wages to many Australian workers, higher profits to many Australian companies, and increased mining royalties and taxes collected by the Australian government. In addition, trade with China has provided Australian consumers with competitively priced manufactured goods; the combined effect has been a higher standard of living for the majority of Australians. Australia and China continue to be solid partners each mutually benefiting from growth in both nations.

The challenge facing China is how, as a centrally planned economy with 60% public ownership of its industry, to pursue its essentially 'commercial' national interest of purchasing resources at the best possible price, to support its rapid industrial development, within the framework of international markets. The challenge confronting Australia is how to accommodate large government investment while maintaining the operation of free market principles.

The Australian Government must carefully consider how to best manage the Australian industry over the long term. It must balance the requirement to maximize the benefits of foreign investment; while, safeguarding against too much foreign government influence. This must include maintaining favorable macroeconomic conditions to reduce Australia's current account deficit. It is Australia's current account deficit that (together with that of other nations) is an underlying reason for both the accumulation of SWFs and for Australia's need to accept foreign investment (in order to finance its current account deficit).

Investigation identifies that the Singapore Government owns the bulk of electrical utilities in the Australian State of Victoria; while, the Dubai Government owns operations at Australia's five largest ports. A comparison to other nations found that the United States, New Zealand and Japan have chosen to reject applications for similar levels of foreign ownership in similar industries on national security grounds. An assessment of the capacity for Singapore or Dubai to influence the strategic decisions of the Australian Government finds that in the event of hostilities between one of these nations and Australia, each nation has some capacity to influence the Australian Government. However, due to the limited means to exercise influence and the current positive relations between nations it is assessed that this ownership does not pose a significant threat to Australia.

The French public sector owns 19% of Australia's largest defense contractor Thales Australia. It is assessed that this is a practical outcome of the globalization of capital and technology in the defense industry. Australia must engage foreign capital and foreign expertise in order to obtain the best contractor support to its defense force. This

level of foreign ownership in the Australian defense industry is largely unavoidable and on balance offer considerable benefits to the development of Australia defense capability. Nevertheless, Australian policy makers should continue to monitor developments within the defense industry.

The release of the six *Principles Guiding Consideration of Foreign Government Related Investment in Australia*, by the Australian Treasurer in February 2008, provides reassurance that Australian policy makers are aware of the threats and opportunities associated with SWFs, and furthermore, that they are prepared to intervene when needed to protect the national interest. Australian policy provides the Treasurer with considerable discretion in determining what constitutes the national interest. Existing policy, supplemented by the six new principles provides strong mitigation against the threats associated with SWFs. Debate has included concern that regulation may discourage needed capital investment in Australia. When releasing the new principles the Treasurer was sure to tell the holders of SWFs that Australia is open for business, but required transparent and regulated investment activity. There is certainly difficult ongoing action required by the Australian Government to manage a delicate balance of foreign investment that maximizes the benefits of foreign investment in Australian, while safeguarding against the threats.

SWF investment in developing nations within Australia's area of interest, the Asia Pacific region, is likely to continue. These nations are less likely to have the regulatory mechanisms to control investment, and they are more desperate to receive investment funding to assist in overcoming endemic economic and social problems. Chinese and Taiwanese SWF activity in the Asia Pacific region has the potential to indirectly affect

Australia's national interests. As unregulated and opaque SWFs investment has the potential to lead to corruption and instability in the region; restoring stability may require Australian intervention. If delivered responsibly aid and investment from other nations has the potential to support Australian interests in the region. The voluntary 'Santiago principles' provide a positive step toward ensuring responsible, transparent and regulated SWF activity. Australian officials should use bilateral and multilateral forums to request compliance with the Santiago Principles.

Independence theory suggests that there is an opportunity for increased cooperation between nations as a result of SWFs; however, there is also a risk that interdependence can limit the strategic freedom of action of a nation receiving investment. There also remains small residual risk that a nation holding SWFs could aggressively sell its investments over a short period of time to deliberately disturb Australian financial markets in order to apply political pressure. Such action is possible; however, it is remote and is not a significant concern when viewed against the benefits of SWF investment. Nevertheless, Australian policy makers should continue to monitor the development of interdependence resulting from SWFs.

National security can be a greatly abused term. Ongoing assessment of emerging and potential challenges and threats to national security is prudent. However, reference to threats to national security should be reserved for events that seriously undermine: territorial sovereignty, democratic freedoms, the rule of law, or fundamental economic prosperity.² As Ungerer suggested, "non-traditional security risks only become a national security risk when they meet the benchmarks of scale, proximity and urgency." Furthermore, what constitutes a threat "can be limited by the range and availability of

resources to respond.”³ At present SWF do not meet the definition of a threat to Australia’s national security, a title that must be reserved for the most serious events. This does not mean that research into SWFs is unimportant, or that without continued vigilance SWFs cannot evolve into a threat to national security. SWFs do continue to pose a significant challenge to policy makers, in particular for the Department of the Treasury and the FIRB (and overlapping into several other policy areas) as they adjudicate on appropriate levels of foreign ownership. However, at this time, the challenge posed by SWFs effects shades of economic prosperity, and challenges to peripheral regional security issues, rather than threats to Australia’s national security.

Recommendations

The following recommendations are provided for Australian policy makers. Evidence suggests that SWFs will continue to grow in size and reach; as such, Australian policy makers should continue to monitor foreign government investment activity in Australia. The Australian Government must carefully consider how to best manage Australian industry over the long term. It must balance the requirement to maximize the benefits of foreign investment, while safeguarding against the challenges of foreign government influence in domestic industries. This must include maintaining favorable macroeconomic conditions to manage Australia’s current account deficit.

Australia should continue to engage China and Taiwan via bilateral and multilateral forums to discuss the management of aid and investment in the Asia Pacific. This should include an appeal for adherence to the new Santiago Principles, and the OECD Development Assistance Committee (DAC) principles for foreign aid.

In regards to national security policy, at the Federal level Australian has separate department 'White Papers'; however, it does not have an overarching 'National Security Statement,' although one has been considered. SWFs present a complex asymmetric challenge that crosses over many policy areas and functional areas of responsibility, including: Department of the Treasury; Department of Foreign Affairs and Trade; Department of Defence; Department of Energy, Resources and Tourism; and Attorney Generals Department, amongst others. In addition to SWFs, several other emerging challenges cross existing functional areas of responsibility including: terrorism, transnational crime, border security, pandemic disease, energy security and climate change. Australian policy makers should consider establishing a National Security Statement as an overarching document to strengthen the interagency whole-of-government approach required to protect Australia against emerging asymmetric challenges and threats to national security. The National Security Statement should categorize and prioritize challenges and threats, and appoint an appropriate agency to take the lead on each issue, while ensuring whole-of-government consultation is maintained. The National Security Statement should also guide ongoing consultation between government departments to ensure appropriate knowledge management of emerging challenges and threats, promoting innovative whole-of-government solutions to the complex policy challenges.

Recommendation for Future Research

As SWFs continue to grow and as the debate in international agencies continues, along with the progress of international guidelines, further Australian research is recommended in order to monitor the developments. The emerging nature of SWFs and

the evolving policy responses make it difficult to recommend a specific area of research. However, the Australian energy and resource industries, along with the management of investment in the Asia Pacific region must be central to any future study.

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³ Carl Ungerer, *A New Agenda for National Security*, Australian Strategic Policy Institute, Special Report 15, Apr 2008. <http://www.aspi.org.au/news/pressrelease.aspx?id=3469> (accessed 20 Sep 2008). 1.

GLOSSARY

Economic Security. Safeguarding the structural integrity and prosperity-generating capabilities and interests of a political-economic entity in the context of various externalized risks and threats that confront it in the international economic system”.¹

Foreign Direct Investment (FDI). FDI is defined as a private company from one country making a long-term investment in a controlling interest of a company in another country. A controlling interest is defined by the IMF as owning 10% or more of the ordinary shares or voting power of an incorporated firm or its equivalent in an unincorporated firm. FDI often consists of a foreign parent company and a domestic affiliate which together form a multinational corporation.²

Portfolio Investment. A percentage of foreign ownership less than 10% is known as a portfolio investment.³

Sovereign Wealth Fund (SWF). A state-owned investment fund composed of financial assets such as stocks, bonds, real estate, or other financial instruments funded by government foreign exchange reserves.⁴

State Owned Enterprise (SOE). The term SOE, is used interchangeably with the terms government owned corporation, or government business enterprise. The defining characteristics of an SOE are: they are government owned companies, established to operate in commercial affairs, they may also have public policy objectives.

¹ Alan Collins (Ed.), *Contemporary Security Studies*, (Oxford: Oxford University Press, 2007). 210.

² United Nations Conference on Trade and Development, *Foreign Direct Investment*,. <http://www.unctad.org> (accessed 21 Sep 2008).

³ International Monetary Fund (IMF), 1993. Balance of Payments Manual, fifth edition, Washington, DC. <http://www.imf.org/external/pubs/ft/bopman/bopman.pdf> (accessed 21 Sep 2008).

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APPENDIX A

SOVEREIGN WEALTH FUNDS

Country	SSWF Fund Name	Assets \$Billion	Date of Inception	Origin (Oil or non-commodity)	SWF to Foreign Exchange Reserve Ratio	Linaburg-Maduell Transparency Index (10 is good)
UAE - Abu Dhabi	Abu Dhabi Investment Authority	\$875	1976	Oil	29.5	3
Norway	Government Pension Fund – Global	\$396.5	1990	Oil	7.1	10
Saudi Arabia	SAMA Foreign Holdings	\$365.2	n/a	Oil		2
Singapore	Government of Singapore Investment Corporation	\$330	1981	Non-Commodity	1.9	6
China	SAFE Investment Company	\$311.6**		Non-Commodity	0.2	2
Kuwait	Kuwait Investment Authority	\$264.4	1953	Oil	12.7	6
China	China Investment Corporation	\$200	2007	Non-Commodity	0.1	6
Russia	National Welfare Fund	\$189.7*	2008	Oil	0.3	5
China - Hong Kong	Hong Kong Monetary Authority Investment Portfolio	\$173	1998	Non-Commodity	1.0	7
Singapore	Temasek Holdings	\$134	1974	Non-Commodity	0.9	8
China	National Social Security Fund	\$74	2000	Non-commodity	Nil	5
Qatar	Qatar Investment Authority	\$60	2003	Oil	8.6	5
Libya	Libyan Investment Authority	\$50	2006	Oil	0.8	2
Algeria	Revenue Regulation Fund	\$47	2000	Oil	0.3	1
Australia	Australian Future Fund	\$43.8	2004	Non-Commodity	1.8	9

US - Alaska	Alaska Permanent Fund	\$39.8	1976	Oil	0.5	10
Kazakhstan	Kazakhstan National Fund	\$38	2000	Oil	1.1	n/a
Ireland	National Pensions Reserve Fund	\$30.8	2001	Non-Commodity	36.6	8
South Korea	Korea Investment Corporation	\$30	2005	Non-Commodity	0.1	9
Brunei	Brunei Investment Agency	\$30	1983	Oil		1
Malaysia	Khazanah Nasional	\$25.7	1993	Non-Commodity	0.3	4
Chile	Social and Economic Stabilization Fund	\$21.3	1985	Copper	0.9	under review
Canada	Alberta's Heritage Fund	\$16.6	1976	Oil	0.4	9
US - New Mexico	New Mexico State Investment Office Trust	\$16	1958	Non-Commodity	0.2	9
New Zealand	New Zealand Superannuation Fund	\$14.7	2003	Non-Commodity	0.8	10
Bahrain	Mumtalakat Holding Company	\$14	2006	Oil	2.9	6
Iran	Oil Stabilisation Fund	\$12.9	1999	Oil	0.2	1
Nigeria	Excess Crude Account	\$11	2004	Oil	0.2	1
Azerbaijan	State Oil Fund	\$10.2	1999	Oil	0.6	9
UAE - Abu Dhabi	Mubadala Development Company	\$10	2002	Oil	n/a	6
Botswana	Pula Fund	\$6.9	1966	Diamonds & Minerals	0.7	1
Oman	State General Reserve Fund	\$6.0	1980	Oil & Gas	0.3	1
Saudi Arabia	Public Investment Fund	\$5.3	2008	Oil	Nil	3
China	China-Africa Development Fund	\$5.0	2007	Non-Commodity	Nil	4
US - Wyoming	Permanent Wyoming Mineral Trust	\$3.9	1974	Minerals	nil	8

	Fund					
East Timor	Timor-Leste Petroleum Fund	\$3.2	2005	Oil & Gas	X	6
US - Alabama	Alabama Trust Fund	\$3.1	1986	Gas	Nil	6
Trinidad & Tobago	Heritage and Stabilization Fund	\$2.4	2000	Oil	n/a	5
Vietnam	State Capital Investment Corporation	\$2.1	2006	Non-Commodity	0.1	4
UAE - Ras Al Khaimah	RAK Investment Authority	\$1.2	2005	Oil	X	3
Venezuela	FIEM	\$0.8	1998	Oil	Nil	1
Kiribati	Revenue Equalization Reserve Fund	\$0.4	1956	Phosphates	n/a	1
Mauritania	National Fund for Hydrocarbon Reserves	\$0.3	2006	Oil & Gas	X	1
UAE – Dubai	Investment Corporation of Dubai	X	2006	Oil	X	4
UAE – Federal	Emirates Investment Authority	X	2007	Oil	X	1
	Total Oil & Gas Related	\$2,434				
	Total Other	\$1,426				
	TOTAL Declared (From Data)	\$3,860				
	TOTAL Estimated	\$4,300				

*This includes the oil stabilization fund of Russia.

**This number is an estimation.

***All figures quoted are from official sources, or, where the institutions concerned do not issue statistics of their assets, from other publicly available sources. Some of these figures are best estimates as market values change day to day. Updated 2 Oct 2008.

(Linaburg-Maduell Transparency Index explanatory table below)

Point	Principles of the Linaburg-Maduell Transparency Index
+1	Fund provides history including reason for creation, origins of wealth, and government ownership structure
+1	Fund provides up-to-date independently audited annual reports
+1	Fund provides ownership percentage of company holdings, and geographic locations of holdings
+1	Fund provides total portfolio market value, returns, and management compensation
+1	Fund provides guidelines in reference to ethical standards, investment policies, and enforcer of guidelines
+1	Fund provides clear strategies and objectives
+1	If applicable, the fund clearly identifies subsidiaries and contact information
+1	If applicable, the fund identifies external managers
+1	Fund manages its own web site
+1	Fund provides main office location address and contact information such as telephone and fax

Developed by Carl Linaburg and Michael Maduell.
Source: SWF Institute Inc. 2008.¹

APPENDIX B

FOREIGN GOVERNMENT INVESTMENT IN AUSTRALIA

Investing Government	Australian Industry Receiving Investment			
CHINA	Energy	Resources/Mining	Infrastructure	Services/Other
	China Petrochemical Corporation: \$1 billion, for 60% of Puffin oil field in the Timor Sea.	Chinalco: \$15 billion, for 11% of Rio Tinto (3 Feb 08). ²	Chinese Consortium: \$3 billion, Oakajee Port and Rail project in Western Australia (Jan 08).	SAFE Investment Company: Australia's three major banks (ANZ, Commonwealth Bank, and the National Australia Bank) received approx 2-3% Chinese government ownership (Jan 08). ³
	CNOOC: \$5 billion, for 25% of Liquid Petroleum Gas (LPG) venture in North West Shelf.	China Iron and Steel: \$2 billion, for 40% of Channar iron-ore mine in the Pilbara.		
	CITIC: \$500 million, 19.9% of McArthur Coal (Jul 07).	Shanghai Baosteel Group: \$1 billion, for 46% of Eastern Range iron-ore mine in the Pilbara.		
		CITIC: \$400 million, for 22.5% of Portland Aluminum Smelter (1995).		
		Chalco: \$3 billion, for bauxite project near Aurun, Queensland.		
		Anshan Iron & Steel: \$39 million, for 13% of iron-ore miner Gindalbie. Plus \$1.8 billion investment in joint venture (Sep 07).		
		Shougang Corporation: \$56 million, for 13% of iron-ore developer Australian Resources. Plus \$2.1 billion invested in Balmoral South Port Project (Mar 2008).		

		China Metallurgical Group: \$400 million, for Cape Lambert iron-ore project in Western Australia.		
		Sinosteel (Chinese SOE): \$1.3 billion, for 100% of Midwest Iron Ore, in Geraldton, WA.		
SINGAPORE	Energy	Resources/Mining	Infrastructure/Property	Services/Other
	Singapore Power: \$2.1 billion, Victoria's monopoly electricity transmission business Powernet (Jun 2000).		Singapore Capita Land: \$1 billion, for a 55% controlling stake of developer Australand (1995)	Singapore Telecommunications (majority owned by state): \$14 billion, for Optus Telecommunications (2001).
	Singapore Power: \$5.1 billion for TXU energy (April 04)		Singapore Sovereign Fund: \$717 million, 50% of Westfield Parramatta, Australia's 3 rd largest shopping centre (May 07).	Temasek Holdings: \$401 million, for 12% of ABC Learning Childcare (Jun 07).
	Singapore Power: \$4.5 billion, for Alinta, NSW monopoly gas distributor and largest electricity distributor in Victoria (2007).		GIC: \$600 million, for 30% of Myer Melbourne Complex, Shopping Centre (June 07).	
	Temasek, Cityspring infrastructure: \$1.2 billion, for Basslink electricity cable, linking Victoria and Tasmania grids.		Singapore Power: \$5.1 billion for TXU energy (April 04). TXU provides gas and electricity distribution, and electrical generation to 1 million customers in Victoria, and South Australia. ⁴	

MIDDLE EAST	Energy	Resources/Mining	Infrastructure/Property	Services/Other
Dubai			Dubai World: \$7 billion, 50%, of P&O, giving it half of Australia's stevedoring duopoly (Mar 06)	Dubai's Sheikh Mohammed: \$460 million, for Ingham Family thoroughbred, training and bloodstock operations.
Kuwait			Kuwait Government: 50% share of Rialto tower, Australia's tallest office tower, plus three of the buildings on Perth's East Terrace.	
FRANCE	Energy	Resources/Mining	Infrastructure/Property	Services/Other
				The French Public Sector: owns 19% of Thales Australia, Australia's largest defense contractor (Oct 07). ⁵
SWF Action Pending Approval	Energy	Resources/Mining	Infrastructure/Property	Services/Other
All Pending activity listed is Chinese	(China) Sinosteel: applying to establish 60% share (\$160 Million) of Uranium mine at Crocker Well, SA, with PepinNini Minerals. ⁶	Three Chinese SOEs - Sinosteel, Baosteel and Chinalco, are reported to be vying for up to a 20% stake in Fortescue metals, Australia's third largest iron-ore producer. ⁷	Chinese consortium financing 87.5% bid via Yilgarn, for Port and Rail project in Mid-West Region, Western Australia (to link iron ore mines to rail and port). Pending WA Government decision. If awarded will give Chinese ownership of 'mine-to-mill' iron ore processing. ⁸	

		Sinosteel (Chinese SOE): Reapplication for 49% of Murchison Metals, in Geraldton, WA, for \$0.75 billion. FIRB seek 90 days to consider (Jun 08). (After 100% bid was blocked by FIRB.)		
		Sinosteel: applying to establish 60% share (\$160 Million) of Uranium mine at Crocker Well, SA, with PepinNini Minerals. ⁹		
		China Consortium is interested in the float of, Resource Development International that is scheduled for late 2008. Percentage of Chinese interest TBA, company worth an estimated \$5 billion (pending approval)		
SWF investment Blocked by the Australian Government	Energy	Resources/Mining	Infrastructure/Property	Services/Other
		Sinosteel (Chinese SOE): attempt to purchase 100% of Murchison Metals, in Geraldton, WA, for \$1.5 billion. Blocked by FIRB Jun 2008. (Reapplication for 49% is pending approval).		

Source: Stephen Mayne, "Foreign Government Investment in Australia," in *The Mayne Report* (2 Oct 2008), <http://www.maynereport.com/articles/2008/02/15-2200-9287.html> (accessed 20 Oct 2008).
Supplemented with additional information from newspapers where indicated.

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